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## Government-Sponsored Enterprises are Too Big to Fail: Balancing Public and Private Interests

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## *Articles*

# **Government-Sponsored Enterprises Are "Too Big to Fail": Balancing Public and Private Interests**

*by*

CARRIE STRADLEY LAVARGNA\*

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Fannie Mae is "the world's largest floating crap game."

—Oakley Hunter<sup>1</sup>

## I. Introduction

The bank and thrift problems of the 1980s may represent only the tip of the iceberg of the government bailout of financial institutions. As of 1991, over one trillion dollars in debt had been issued by quasi-public corporations known as government-sponsored enterprises (enterprises).<sup>2</sup> These part-private, part-public institutions are indispensable components of the nation's economy and are "too big to fail."<sup>3</sup> Several of the enterprises are among the largest financial institutions in the United States. Most notably, the Federal National Mortgage Association (Fannie Mae) ranks as the sixth-largest corporation in the nation.<sup>4</sup> The enterprises are

1. Oakley Hunter, Former Chairman and President, Federal National Mortgage Association, *quoted in* Curtis W. Tuck, *The Secondary Mortgage Market*, in *THE STORY OF HOUSING* 399, 419 (Gertrude S. Fish ed., 1979).

2. U.S. GENERAL ACCOUNTING OFFICE, *GOVERNMENT-SPONSORED ENTERPRISES: A FRAMEWORK FOR LIMITING THE GOVERNMENT'S EXPOSURE TO RISKS* 2 (1991) [hereinafter GAO, *A FRAMEWORK FOR LIMITING THE GOVERNMENT'S EXPOSURE TO RISKS*]. The debt of government-sponsored enterprises and the contingent liability of the federal government are excluded from the federal budget. From 1987 to 1989, these enterprises borrowed more money to service their debt than the federal government did to service its own. U.S. DEPARTMENT OF THE TREASURY, *REPORT OF THE SECRETARY OF THE TREASURY ON GOVERNMENT SPONSORED ENTERPRISES* 2 (1990) [hereinafter *TREASURY REPORT*].

3. "Too big to fail" describes the federal government's voluntary commitment to keep troubled institutions operating—a commitment undertaken because their failure would have a far worse effect on the economy than would the cost of rescuing them. See Cheryl D. Block, *Overt and Covert Bailouts: Developing a Public Bailout Policy*, 67 *IND. L.J.* 951, 968-72 (1992).

4. U.S. GENERAL ACCOUNTING OFFICE, *BUDGET ISSUES: PROFILES OF GOVERNMENT-SPONSORED ENTERPRISES* 47 (1991) [hereinafter GAO, *PROFILES OF GOVERNMENT-SPONSORED ENTERPRISES*]. The Student Loan Marketing Association (Sallie Mae), also an enterprise, ranks among the nation's 100 largest public corporations and 20 largest nonbank

privately owned corporations chartered by Congress to further public policy goals. Congress created each enterprise to benefit the public by serving as a financial intermediary for particular sectors of the economy that were inadequately served by the private capital markets. Through secondary markets, the enterprises buy and sell mortgages and student loans, thereby enhancing the availability of reliable credit to farmers, homeowners, colleges, and educators.<sup>5</sup> Because of the enterprises' size and important contributions to society, the federal government would not permit any of them to fail. The havoc such a failure would wreak on the nation's economy would be more costly than a government bailout.

Since Congress created the first of these quasi-governmental corporations over sixty years ago,<sup>6</sup> the relationship between the enterprises' private owners and the public sector has lacked clear definition.<sup>7</sup> As federal "instrumentalities" created to fulfill a governmental purpose by way of normal profit-making activities associated with private industry, the enterprises remain subject to some federal laws, while enjoying exemption from others.<sup>8</sup> Their size and their importance to the national economy compound the basic question plaguing any quasi-governmental entity: What is the government's responsibility for these enterprises?<sup>9</sup> Uncertainty about the scope of the government's role in supervising, controlling, and managing these enterprises extends from the halls of Congress to Wall Street. It largely derives from the erroneous perception

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financial institutions; it has provided over \$40 billion in funds and commitments for educational loans. *Id.*

5. U.S. GENERAL ACCOUNTING OFFICE, GOVERNMENT-SPONSORED ENTERPRISES: THE GOVERNMENT'S EXPOSURE TO RISKS 2 (1990) [hereinafter GAO, THE GOVERNMENT'S EXPOSURE TO RISKS]. The enterprises match the centralized supply of investment capital with the decentralized demand for that capital. The size of the enterprises' secondary mortgage market is second only to the market for United States Treasury securities. GAO, PROFILES OF GOVERNMENT-SPONSORED ENTERPRISES, *supra* note 4, at 26.

6. Congress created some of the enterprises to remedy the effects of the Great Depression. See *infra* Part II.B.

7. See Richard W. Bartke, *Fannie Mae and the Secondary Mortgage Market*, 66 NW. U. L. REV. 1, 55 (1971) (discussing Fannie Mae's "split personality"); Comment, *FNMA and the Rights of Private Investors: Her Heart Still Belongs to Daddy*, 59 GEO. L.J. 369, 370 (1970) (focusing on conflict between public corporate policy and the private rights of shareholders).

8. See *infra* Part III.C.

9. Questions surrounding the dual personality of these federal instrumentalities have existed since the first national bank was created in 1791. In 1824, for example, during oral argument in *Osborn v. Bank of the United States*, counsel asked the Supreme Court: "Can an institution, then purely private, and which disclaims public character, be clothed with the power and rights of the government . . . ?" 22 U.S. (9 Wheat.) 738, 781-82 (1824) (argument of petitioner's counsel); see MICHAEL P. MALLOY, THE REGULATION OF BANKING 22 (1992).

pervading the financial markets that enterprise debt is backed by the full faith and credit of the United States government.<sup>10</sup>

Like the enterprises, nationally chartered banks and thrifts constitute privately owned federal instrumentalities.<sup>11</sup> An inevitable conflict between private ownership and government interests arose during the banking and thrift crisis of the 1980s. Concerned that the enterprises showed many of the same symptoms as the troubled thrift industry,<sup>12</sup> Congress passed the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (Safety and Soundness Act) to bolster regulatory supervision of three of the largest enterprises.<sup>13</sup> Although no enterprise was in jeopardy of immediate failure, Congress recognized that the enterprises, like private financial institutions, face the possibility of failure.<sup>14</sup>

As we have learned from the bank and thrift failures, the tension between private and public interests inherent in federal instrumentalities becomes more intense if the entity becomes financially troubled.<sup>15</sup> In case of failure, the Safety and Soundness Act empowers federal regulators to appoint a conservator for the financially troubled enterprise.<sup>16</sup> The appointment of a conservator, however, causes the private- and public-sector interests to become adversarial. The federal government's resolution of the bank and thrift failures provides a relevant parallel, and demonstrates how the murky standard of corporate responsibility inade-

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10. See TREASURY REPORT, *supra* note 2, at 1. The enterprises receive virtually no government appropriations; they derive their financing from the issuance of short- and long-term debt. Because the enterprises have significant ties with the federal government, and because their debt obligations are issued in the same manner as United States Treasury debts (which are federally guaranteed), the public perception is that the federal government guarantees the enterprises' debts as well. *Id.*

11. See *infra* text accompanying note 115.

12. GAO, A FRAMEWORK FOR LIMITING THE GOVERNMENT'S EXPOSURE TO RISKS, *supra* note 2, at 2. The thrift industry debacle prompted Congress to pass the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), Pub. L. No. 101-73, § 1404, 103 Stat. 183, 551.

13. Pub. L. No. 102-550, § 1301, 106 Stat. 3672, 3941 (codified at 12 U.S.C. § 4619 (Supp. IV 1992)) (covering Fannie Mae, Freddie Mac, and the Federal Home Loan Banks). Congress modeled the 1992 Safety and Soundness Act after the savings and loan bailout legislation that dramatically increased the government's regulatory powers. *Cf.* FIRREA. Similar legislation is pending for the other major enterprises. See S. 1915, 102d Cong., 1st Sess. (1991) (Sallie Mae); H.R. 3083, 102d Cong., 1st Sess. (1991) (Sallie Mae); H.R. 3298, 102d Cong., 1st Sess. (1991) (Farm Credit System); H.R. 3300, 102d Cong., 1st Sess. (1991) (Farmer Mac).

14. See GAO, THE GOVERNMENT'S EXPOSURE TO RISKS, *supra* note 5, at 2. The enterprises are subject to the same risks as other private financial companies—fluctuating market interest rates, loan defaults, and other credit problems; improper management decisions; and external business factors such as natural disasters, industry competition, and changes in technology, demography, or legislation. *Id.* at 31.

15. See MALLOY, *supra* note 9, at 717-809.

16. See Safety and Soundness Act § 4620.

quately defines the interaction of these competing interests. In the 1980s, zealous federal regulators viewed private parties as the culprits responsible for the massive losses of the banking and thrift industry.<sup>17</sup> Consequently, the regulators grossly disregarded any competing private interests.

Despite vehement challenges by the private sector, most courts followed the regulators' lead by upholding the government's interest, to the apparent exclusion of the interests of shareholders, creditors, and borrowers. From the ruins of the banking and thrift industries, a new standard of corporate responsibility for federal instrumentalities emerged under which government interests superseded all others. The intrinsic flaw in this new standard lies in its disregard for the vital role played by the private sector. Congress created federal instrumentalities to fulfill public policy goals through the private sector's efficient profit-making incentives. The government should supervise the enterprises to protect against abuses of this privilege by the private sector, but should not disregard private-sector interests in times of trouble.

This Article argues that a new standard of corporate responsibility must be developed for federal instrumentalities—a standard that balances the interests of the public and private sectors. Neither the traditional corporate concepts of shareholder wealth maximization, nor the federal supremacy standard works well for these quasi-public corporations. Rather, a standard that focuses on the best interests of the enterprise would best sustain and balance the competing public and private interests. It is naive to believe that an enterprise's government-appointed conservator would weigh private parties' interests fairly in the midst of a government-assisted financial rescue. Therefore, private parties should insist that Congress provide a structure that would balance all relevant interests in the reorganization of an enterprise. Although the Safety and Soundness Act allows for the appointment of a conservator for a troubled enterprise,<sup>18</sup> it does not adequately address the priorities of the private and public interests in such a reorganization. By addressing these issues prospectively rather than retroactively, as was the case with the savings and loan crisis,<sup>19</sup> the private sector might be able to work better with Congress to allocate such risk properly.

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17. See Major Causes of the Thrift Crisis, H.R. REP. NO. 101-54, 101st Cong., 1st Sess., pt. 1, at 294 (1989).

18. See Safety and Soundness Act, § 4620.

19. One of the reasons Congress passed FIRREA in 1989 was the recognition that federal law concerning the appointment of a conservator or receiver of a federally insured depository institution required sweeping changes. See *infra* notes 225-234 and accompanying text.

Collectively the enterprises have assumed almost one trillion dollars of debt. Prudence demands that creditors fully anticipate and prepare for the debtors' insolvency.<sup>20</sup> The enterprises' private-sector creditors should consider and redefine their rights before an enterprise becomes insolvent. A balanced reorganization plan could provide a framework to protect the public and private interests at stake, not only in the ordinary course of business, but through financial crises as well. The costly lessons of the banking and thrift debacle illustrate the inadequacy of Congress's previous approach to resolving crises in federal instrumentalities, and mandate a new solution for government-sponsored enterprises—a solution that equitably balances private and public interests.

Enterprises rank among the largest financial institutions in America, but because they conduct their business in the secondary markets, the general public lacks direct awareness of their operation.<sup>21</sup> In an effort to dispel the aura of mystery surrounding them, this Article explains the nature of the enterprises and their role in the secondary markets. This Article discusses controversies between public- and private-sector interests in federal instrumentalities, and examines the traditional standard of corporate responsibility and the new standard emerging from the banking and thrift crisis. It then considers the application of these standards to an enterprise, to private reorganization, and to future government assistance. Finally, this Article proposes strategies to fairly balance the competing private and public interests in the enterprises.

Part II profiles the nature and history of the enterprises and their role in the financial markets. An explanation of the secondary markets illustrates how the enterprises developed private capital markets, thereby using private investment to promote public policy. Part III discusses the private corporate standards and public agency responsibilities. Since banks, thrifts, and the enterprises are considered "federal instrumentalities," this Part introduces the law on that subject. Part III then explains the twin catalysts propelling the enterprises toward problems similar to those seen in the banking and thrift crisis: the implicit government guarantee and the government's "too big to fail" policy. Part IV introduces the legislative response, the Safety and Soundness Act of 1992, in which

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20. See DON CAMPBELL ET AL., CREDITORS' RIGHTS HANDBOOK: A GUIDE TO THE DEBTOR-CREDITOR RELATIONSHIP 7 (2d ed. 1992).

21. The secondary market is the fastest growing segment of the U.S. capital markets, and one of the least understood sectors of the economy. Fannie Mae, Freddie Mac, Sallie Mae, and Farmer Mac are restricted by law to the secondary market. See THOMAS H. STANTON, A STATE OF RISK: WILL GOVERNMENT-SPONSORED ENTERPRISES BE THE NEXT FINANCIAL CRISIS 15 (1991). For an overview, see THE SECONDARY MORTGAGE MARKET (Jess Lederman ed., 1987).

Congress chose to translate the experience of the failed banks and thrifts to the context of the enterprises. The new grant of power allowing an agency to appoint a conservator for a financially troubled enterprise parallels the government's response to the banking and thrift crisis. Part V discusses the government's role as conservator of failed financial institutions and examines the case law that changes the rights and responsibilities of the private interests. This Part focuses on attempts by shareholders, creditors, and borrowers to challenge government actions. It discusses the resulting standard of corporate responsibility and illustrates the deficiencies in such an approach. Part VI distinguishes banks and thrifts from the enterprises and explains why the continued operation of the enterprises is essential to the nation.<sup>22</sup> Significant differences between the banks and the enterprises, however, mandate a different solution. Accordingly, this final Part proposes a strategy which would reorganize a financially troubled enterprise to equitably balance government and private interests and ensure the continued operation of the enterprise. This Article concludes that Congress should prospectively provide a forum for consideration of private parties' interests in the event of an enterprise's insolvency. Consideration of private interests would ensure the continued successful existence of the enterprise and the public-private partnership it represents.

## II. Government-Sponsored Enterprises

### A. The Secondary Markets

The federal government has used enterprises to promote and facilitate public policy goals for over eighty-five years.<sup>23</sup> These enterprises support the government's policy objectives by creating secondary markets that facilitate the flow of credit to home buyers, farmers, students, and colleges. Secondary markets integrate primary lending markets with the capital markets.<sup>24</sup> In the primary market, lenders deal directly with

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22. The enterprises are financial institutions subject to market forces and are, by definition, risk-taking entities. The belief that an enterprise may become financially weakened and require federal assistance is not farfetched. See GAO, *THE GOVERNMENT'S EXPOSURE TO RISKS*, *supra* note 5, at 2, 31.

23. Since the creation of the first enterprise in 1916, Congress has chartered eleven enterprises to finance sectors of society that had not been adequately served by the private credit markets, including housing, agriculture, and education. Congress is considering the creation of "Velda Sue," Venture Enhancement and Loan Development Administration for Smaller Undercapitalized Enterprises, to support loans to small business. Udayan Gupta, *Venture Capitalists Raised 75% More Money Last Year*, WALL ST. J., Jan. 29, 1993, at B2.

24. The capital markets represent the supply of money, while the lending markets provide demand for money. See generally, Kenneth J. Thygersson, *Federal Government-Related*



borrowers by originating loans for home buyers, farmers, and students. Prior to the creation of the secondary markets, primary lenders had to balance their lending practices with the deposits they received.<sup>25</sup> This forced balancing created severe credit shortages during economic downturns, when demand for loans increased and the source of primary lending—savings accounts—was depleted by depositor withdrawals. In effect, the amount of credit available for new loans dried up. The concentration of capital markets in major money centers, such as New York and Chicago, exacerbated this effect. For example, a student in South Dakota who was unable to obtain a student loan from local lending institutions would have had no access to banks in Chicago or New York. Likewise, an investor in San Francisco having money available for the extension of credit would have had no access to credit-worthy farmers in Iowa. Enterprises serve as intermediaries, integrating the supply of money in the capital markets with the primary lenders' demand for money, thereby eliminating a substantial barrier to the operation of supply and demand for lending capital.<sup>26</sup>

The key to the role of enterprises lies in the "securitization" of primary loans.<sup>27</sup> The enterprises buy loans from primary lenders, pool the loans into portfolios, and then sell the portfolios (or portions thereof) to investors and others in the capital markets.<sup>28</sup> Securitizing the loans<sup>29</sup> makes the asset more marketable and assures the enterprises access to ready investment markets.<sup>30</sup> This secondary market permits primary lenders to sell their loans, and thereby obtain the cash with which they

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*Mortgage Purchaser*, in THE HANDBOOK OF MORTGAGE BANKING: A GUIDE TO THE SECONDARY MORTGAGE MARKET 57 (James M. Kinney & Richard T. Garrigan eds., 1985).

25. Known as the "credit function," the aggregate amount of loans will be exponentially higher than the aggregate amount of deposits from which the loan funds are generated. See MALLOY, *supra* note 9, at 381.

26. Notes and mortgages are deemed assets of the owner and are bought and sold regularly, as are stocks and bonds. Tuck, *supra* note 1, at 399.

27. The growth in asset securitization is deemed to be one of the most significant financial innovations of the last twenty years. See, e.g., JAMES A. ROSENTHAL & JUAN M. OCAMPO, SECURITIZATION OF CREDIT: INSIDE THE NEW TECHNOLOGY OF FINANCE 3 (1988). No specific legal meaning exists for "securitization," and the term is often used to mean a variety of things. Broadly, securitization is the transformation of illiquid assets, such as mortgages, into tradeable securities with a secondary market. Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1373-75 (1991).

28. The enterprises finance the purchase of the portfolio loans by issuing short-term debt. See Thygeson, *supra* note 24, at 58.

29. A mortgage-backed security is a certificate, secured by a pool of mortgages, which entitles the certificate owner to payments from cash flow generated by the mortgages. Shenker & Colletta, *supra* note 27, at 1383-88.

30. *Id.* at 1374-75.

may make new loans. In this manner, the secondary market provides a constant source of funds for loans and stabilizes the availability of loans to targeted groups of borrowers such as farmers, students, and home buyers.

The secondary markets have achieved success by reducing the economic risk of loss in owning mortgages and other loans.<sup>31</sup> Rather than forcing primary lenders or individual investors to assume all risk,<sup>32</sup> the secondary markets have reduced aggregate risk by spreading the risks among the investors through pooling mortgages and selling ownership interests in the pool.<sup>33</sup> This reallocation of risks has expanded the availability of loans to disadvantaged borrowers.<sup>34</sup> Linking the capital markets to this process has increased the supply of available capital and reduces the cost of loans through more efficient movement of capital.<sup>35</sup>

## B. Profile of the Enterprises

Notwithstanding their Congressional charter and unique ties to the federal government,<sup>36</sup> enterprises are owned mainly by private parties, who control most of the stock and manage the enterprises within the broad policy guidelines set by Congress.<sup>37</sup> Eleven enterprises currently operate in different sectors of the economy—four for agriculture,<sup>38</sup> five for housing,<sup>39</sup> and two for education.<sup>40</sup> The following discussion profiles the largest enterprises.

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31. *Id.* at 1375.

32. The risks of owning mortgages include interest rate fluctuations, defaults by borrowers, and prepayment. Residential mortgages are generally long-term loans but allow the borrower to prepay the loan without penalty. When interest rates decline, residential mortgages are often refinanced and prepaid. The lender then has to invest its principal at lower rates yielding less on the investment over time. *Id.* at 1393-94.

33. The secondary mortgage market can be compared to the market for common stocks, which allows a business owner to divest some of the risks and benefits of the business and permit others to share in the benefits and losses. Kenneth J. Arrow, *Insurance Risk and Resource Allocation*, in *ESSAYS IN THE THEORY OF RISK-BEARING* 134-35 (Kenneth J. Arrow ed., 1971).

34. *Id.*

35. See Shenker & Colletta, *supra* note 27, at 1375.

36. See *infra* notes 128-131 and accompanying text.

37. See generally GAO, A FRAMEWORK FOR LIMITING THE GOVERNMENT'S EXPOSURE TO RISKS, *supra* note 2, at 3.

38. The Banks for Cooperatives, the Farm Credit Banks, the Financial Assistance Corporation (FAC), and the Federal Agricultural Mortgage Corporation (Farmer Mac).

39. The Federal Home Loan Banks, the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), the Financing Corporation (FICO), and the Resolution Funding Corporation (Refcorp).

40. The Student Loan Marketing Association (Sallie Mae) and the College Construction Loan Insurance Association (Connie Lee).

*Farm Credit System.* In 1916, Congress established the first enterprise, the Farm Credit System (FCS),<sup>41</sup> to provide a dependable source of agricultural credit at competitive rates.<sup>42</sup> The statutory policy objectives of the FCS include furnishing credit and related services to farmers, ranchers, and their cooperatives to promote efficient farm operations; encouraging borrower participation, control, and ownership of a permanent system of credit for farmers and ranchers; and improving credit for housing in rural areas.<sup>43</sup> The FCS consists of a nationwide network of lending institutions within twelve Farm Credit Districts, which provides services and loans directly to farmers, ranchers and agricultural credit associations.<sup>44</sup> Created as cooperatives, FCS banks are owned and controlled by the borrowers.<sup>45</sup> Selling system-wide debt securities, rather than collecting deposits, provides the primary basis of funding.<sup>46</sup> The FCS encountered serious financial problems in the 1980s, due in part to the agricultural recession.<sup>47</sup> In 1987, Congress bailed out the FCS, at a cost that could ultimately reach five billion dollars.<sup>48</sup>

*Federal Home Loan Bank System.* During the Depression, large-scale withdrawals of deposits, defaults on mortgage loans, and the consequent cash shortage caused the failure of many thrifts. In response, Congress established the Federal Home Loan Bank System in 1932<sup>49</sup> as a centralized credit facility to provide funds to the thrift industry and to

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41. The Federal Farm Loan Act of 1916, Pub. L. No. 64-158, 39 Stat. 360 (codified as amended at 12 U.S.C. § 672 (1988)).

42. The Farm Credit System has expanded over the years to include the Federal Intermediate Credit Banks, the Production Credit Associations, and the Banks for Cooperatives. In 1987, the Federal Land Banks and the Intermediate Credit Banks merged to form the Farm Credit Banks. Agricultural Credit Act of 1987, Pub. L. No. 92-181, 85 Stat. 583 (codified at 12 U.S.C. § 2011 (1987)).

43. Farm Credit Act, 12 U.S.C. § 2001 (1988).

44. See TREASURY REPORT, *supra* note 2, at D-1.

45. Stanton, *supra* note 21, at 20.

46. The FCS had almost \$57 billion of publicly traded debt as of December 31, 1989. See TREASURY REPORT, *supra* note 2, at D-1, D-5.

47. At that time, default rates on farm loans rose and the FCS had high-interest-rate risk exposure. Having issued high-cost, long-term debt to fund mostly variable-rate loans, the FCS lost money because it had to continue paying high-cost debt while receiving reduced earnings. See GAO, THE GOVERNMENT'S EXPOSURE TO RISKS, *supra* note 5, at 37.

48. *Id.* at 19. In 1987, the FCS was composed of three enterprises: the Federal Land Banks, the Banks for Cooperatives, and the Federal Intermediate Credit Banks. The FAC was itself an enterprise, established in 1987 to revive the troubled FCS. The FAC-issued debt obligations are guaranteed by the full faith and credit of the U.S. Government. Agricultural Credit Act, 12 U.S.C. § 2278(b) (1987). In 1988, Congress established Farmer Mac, a privately owned corporation, to create a secondary market for farm and rural housing loans. 12 U.S.C. § 2279aa-1 (1988).

49. Federal Home Loan Bank Act of 1932, Act of July 22, 1932, ch. 522, 47 Stat. 725 (codified as amended at 12 U.S.C. §§ 1421-1449 (1988)).

bolster the availability and distribution of residential mortgage loans.<sup>50</sup> Member savings and loan institutions, which owned the Banks,<sup>51</sup> could then borrow funds through the Federal Home Loan Bank System to help control their liquidity.<sup>52</sup> The Banks finance their operations through the proceeds of consolidated debt obligations,<sup>53</sup> interest on advances and loans, member deposits, and the issuance of Bank capital stock.<sup>54</sup>

*Fannie Mae.* The Federal National Mortgage Association (Fannie Mae) began in 1938<sup>55</sup> as an agency of the United States government charged with providing a secondary market for privately made residential mortgages insured by the Federal Housing Administration (FHA) or guaranteed by the Veterans Administration (VA).<sup>56</sup> This secondary market purported to encourage primary lenders to originate FHA/VA loans and to provide the lenders with funds to make new loans.<sup>57</sup> Through the 1960s, the development of Fannie Mae's secondary market proceeded slowly and was limited to the federally insured FHA/VA loans.

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50. See TREASURY REPORT, *supra* note 2, at A-1. During the Depression, the home construction and finance industries came to a virtual halt. People could not buy houses or refinance mortgages because many of the local savings and loans had either failed or were too illiquid to create new loans. *Id.* Like the Federal Land Banks, a series of Federal Home Loan Banks operate in geographical districts to ensure the liquidity of member banks. H.R. 54(I), 101st Cong., 1st Sess. 88-89 (1989).

51. All federal savings associations were required by law to become members of a Bank. Home Owners' Loan Act of 1933, Pub. L. No. 73-43, 48 Stat. 128 (codified as amended at 12 U.S.C. §§ 1461-1467 (1988)). All state-chartered savings associations also had to become Bank members to qualify for deposit insurance with the Federal Savings and Loan Insurance Corporation. National Housing Act of 1934, Pub. L. No. 73-479, 48 Stat. 1246 (codified as amended at 12 U.S.C. §§ 1701-1750 (1988)). Under FIRREA, commercial banks and credit unions with at least 10% of their assets in home mortgages are eligible for membership in the Banks. Pub. L. No. 101-73, § 704(a)(2), 103 Stat. 183, 416 (1989).

52. Until 1989, the Federal Home Loan Bank Board (FHLBB) also regulated the thrift industry. FIRREA transferred the FHLBB's regulatory functions to the newly created Office of Thrift Supervision. Pub. L. No. 101-73, § 301, 103 Stat. 183, 278 (1989). Additionally, FIRREA established a new independent agency, the Federal Housing Finance Board, to oversee the operation of the Federal Home Loan Banks. *Id.* § 403, 103 Stat. at 360-61.

53. As of December 31, 1989, \$137 billion in consolidated debt remained outstanding. TREASURY REPORT, *supra* note 2, at C-3.

54. *Id.* at C-3 to C-6.

55. The Reconstruction Finance Corporation, a federal agency, chartered Fannie Mae (originally the National Mortgage Association of Washington) under the National Housing Act of 1934, Pub. L. No. 73-479, 48 Stat. 246. Fannie Mae's charter was later codified in the Housing Act of 1954, Pub. L. No. 83-560, § 302, 68 Stat. 590, 612-13. See Stanton, *supra* note 21, at 202.

56. Thygeson, *supra* note 24, at 57.

57. See TREASURY REPORT, *supra* note 2, at A-2. The FHA/VA loans were unique because they offered a long-term, fully amortizing 30-year mortgage when the private market traditionally issued short-term loans with steep balloon payments due in three to five years. *Id.* at A-1 to A-2.

In 1968, Congress transferred Fannie Mae to private ownership and management, but maintained its statutory charter and public purpose guidelines.<sup>58</sup> Congress also created a new federal agency, the Government National Mortgage Association (Ginnie Mae), within the Department of Housing and Urban Development, to finance FHA/VA loans.<sup>59</sup>

Before 1970, when Congress authorized Fannie Mae to purchase conventional home mortgages,<sup>60</sup> no organized market for the sale of conventional mortgages existed because of the lack of uniformity in the underwriting and documentation of the conventional mortgages.<sup>61</sup> In 1973, Fannie Mae and Freddie Mac standardized underwriting requirements and loan documents for conventional mortgages, thereby facilitating the substantial increase in the trading of conventional mortgages in the secondary market.<sup>62</sup> During the 1980s, Fannie Mae supplied \$450 billion in mortgage funds. In 1989, it helped to provide housing financing for over one million families.<sup>63</sup>

Fannie Mae finances its operations and purchases of mortgages by issuing general unsecured debt to investors.<sup>64</sup> Fannie Mae pays cash or issues mortgage-backed securities to the primary lenders in exchange for the mortgages.<sup>65</sup> Fannie Mae's mortgage-backed securities consist of trust certificates issued and guaranteed by Fannie Mae and secured by pools of mortgages.<sup>66</sup> As income-earning assets, these securities entitle the owner to a portion of the flow of principal and interest payments on the underlying pool of mortgages. The high liquidity of mortgage-backed securities allows free transferability and negotiability in the capital markets.

*Freddie Mac.* Chartered in 1970 as a part of the Federal Home Loan Bank System, the Federal Home Loan Mortgage Corporation (Freddie Mac) increased the availability of mortgage credit through the

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58. Housing and Urban Development Act of 1968, Pub. L. No. 90-448, § 801-10, 82 Stat. 476, 536-46.

59. Pub. L. 90-448, 82 Stat. 536 (codified as amended at 12 U.S.C. § 1717 (1988)). The obligations and securities issued by Ginnie Mae are backed by the full faith and credit of the U.S. government. Tuck, *supra* note 1, at 409.

60. Emergency Home Finance Act of 1970, Pub. L. No. 91-351, § 201, 84 Stat. 450, 450-51. "Conventional mortgages" refers to loans not insured or guaranteed by the federal government.

61. Conventional mortgages were considered risky investments. *Id.*

62. Thygerson, *supra* note 24, at 58.

63. GAO, PROFILES OF GOVERNMENT-SPONSORED ENTERPRISES, *supra* note 4, at 20.

64. Fannie Mae reported \$116 billion in debt outstanding as of December 31, 1989. TREASURY REPORT, *supra* note 2, at A-3.

65. *Id.* at A-5 to A-6.

66. These obligations are not guaranteed by the federal government.

thrift industry.<sup>67</sup> At the time, the thrift industry generated almost two-thirds of all home mortgages. Demand for home mortgages, however, far outstripped the volume of savings deposits underlying the loans.<sup>68</sup> As a result, the inconsistent supply of funds in several regions of the country caused shortages in the availability of home mortgages.

Through establishing Freddie Mac, Congress intended to create a secondary market for conventional home mortgage loans to improve the supply of funds to the thrift industry.<sup>69</sup> By the end of 1989, Freddie Mac had purchased and retained for its portfolio approximately \$295 billion in residential mortgages.<sup>70</sup> Freddie Mac finances its mortgage purchases through the issuance of mortgage-backed securities and, to a lesser extent, through general unsecured debt.<sup>71</sup> Fannie Mae and Freddie Mac are similar in the manner in which they conduct business, and they virtually control the secondary market for conventional residential mortgages falling within their loan purchase limits.<sup>72</sup>

Freddie Mac began its existence under the private ownership of the Federal Home Loan Banks and the thrift industry.<sup>73</sup> When the Federal Home Loan Bank Board dissolved in 1989, Congress modified Freddie Mac's ownership to permit the free transferability of its stock.<sup>74</sup>

*Sallie Mae.* In 1972, Congress created the Student Loan Marketing Association (Sallie Mae) to provide a secondary market for federally guaranteed student loans.<sup>75</sup> Although the Guaranteed Student Loan

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67. Emergency Home Financing Act of 1970, Pub. L. No. 91-351, tit. III, 84 Stat. 450, 451; see TREASURY REPORT, *supra* note 2, at B-1.

68. *Id.*

69. The Emergency Home Financing Act of 1970 also granted Fannie Mae parallel authority to deal in conventional mortgages. *Id.*

70. *Id.*

71. *Id.* at B-4. Freddie Mac had \$273 billion in mortgage-backed securities outstanding as of 1989. *Id.* at B-37.

72. *Id.* at B-1. The Treasury Report found an intense competition between Fannie Mae and Freddie Mac that makes the secondary market more efficient and benefits consumers with lower mortgage rates. *Id.* at B-17. In 1984, Congress sought to expand private-sector participation in secondary markets by passing the Secondary Mortgage Market Enhancement Act, Pub. L. No. 98-440, 98 Stat. 1689 (1984) (codified as amended at 12 U.S.C. § 1701 (1988)). See Shenker & Colletta, *supra* note 27, at 1385; Paula C. Murray & Beverly L. Hadaway, *Mortgage-Backed Securities: An Investigation of Legal and Financial Issues*, 11 J. CORP. L. 203, 232-34 (1986); Edward L. Pittman, *Economic and Regulatory Developments Affecting Mortgage Related Securities*, 64 NOTRE DAME L. REV. 497 (1989) (tracking the circumstances leading to the adoption of the Secondary Mortgage Market Enhancement Act and its implication for regulators and financial institutions).

73. TREASURY REPORT, *supra* note 2, at B-9.

74. 5 U.S.C. § 903 (1989).

75. Pub. L. 92-318, 86 Stat. 265 (codified as amended at 20 U.S.C. § 1087-2 (1988)).

Program was established in 1965, the long-term illiquidity of the loans rendered lenders reluctant to participate in the program.<sup>76</sup>

In an attempt to translate the success of the secondary market in residential mortgages to the student loan market, Congress chartered Sallie Mae to extend funds to educational institutions and other lenders in order to provide a constant flow of funds to the student loan market.<sup>77</sup> Sallie Mae provides liquidity to primary lenders through the direct purchase of student loans and through warehousing advances.<sup>78</sup> From 1973 through 1989, Sallie Mae provided over forty billion dollars in funds and commitments for educational loans.<sup>79</sup> Sallie Mae's operating funds come primarily from the sale of debt securities.<sup>80</sup> Although privately owned, Sallie Mae ranks among the nation's 100 largest public corporations, and among the twenty largest nonbank financial institutions.<sup>81</sup>

### III. Private/Public Corporations

#### A. Private Corporations

Private business corporations are formed pursuant to state law.<sup>82</sup> In a classic model of corporate governance, the Board of Directors, elected by the shareholders, manages the corporation to maximize the wealth of the shareholders; the corporation's officers and directors owe their fiduciary duties only to the shareholders.<sup>83</sup> This traditional model evolved when individual stockholders participated in the supervision of corporate

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76. *Id.* The guaranteed student loans were long-term, illiquid loans with interest rates capped at below-market rates. *Id.*

77. The scope of Sallie Mae's authority has been expanded over the years, enabling it to include uninsured educational loans in its portfolios, to provide financing to educational institutions, and to supply advances for funding the student loan operations of state and nonprofit agencies. Higher Education Amendments of 1986, Pub. L. No. 99-498, 100 Stat. 1268, 1290; Omnibus Budget Reconciliation Act of 1981, Pub. L. No. 97-35, § 538, 95 Stat. 357, 457; Education Amendments of 1980, Pub. L. No. 96-374, 94 Stat. 1367.

78. GAO, PROFILES OF GOVERNMENT-SPONSORED ENTERPRISES, *supra* note 4, at 47. Warehousing advances are loans made to lenders and secured by insured student loans.

79. *Id.*

80. TREASURY REPORT, *supra* note 2, at F-9. As of December 31, 1989, Sallie Mae's liabilities totaled \$34.5 billion. Initially, the Department of Education had authority to guarantee Sallie Mae's debt instruments, but this authority expired in 1984. *Id.*

81. *Id.*

82. See HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES 25 (3d ed. 1983).

83. Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23, 23 (1991).

management.<sup>84</sup> In recent decades, stock ownership in large corporations shifted from individual to institutional investors.<sup>85</sup> Institutional investors are more interested in the corporations's overall financial success than its management.<sup>86</sup> Because of their large and diverse portfolios, institutional investors have difficulty following the details of management or participating actively in the supervision of corporations.

The increasing influence of the institutional investor and the merger and acquisition phenomenon in the 1980s<sup>87</sup> are shifting the emphasis of corporate governance from maximizing shareholder wealth to preserving the corporation and its community of interests: shareholders, consumers, creditors, and employees.<sup>88</sup> As a result of recent detrimental effects on the corporate community caused primarily by the mergers and acquisition frenzy, twenty-eight states adopted anti-takeover statutes that reject the shareholder wealth standard by allowing the directors greater discretion to consider the interests of the entire corporate community when making business decisions.<sup>89</sup> One of the most important issues

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84. Martin Lipton & Jay W. Lorsch, *A Modest Proposal for Improved Corporate Governance*, 48 BUS. LAW. 59, 60 (1992). See generally ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (Harcourt, Brace & World ed., rev. ed. 1967) (examining the relation between corporations and property); ALFRED D. CHANDLER, JR., *THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS I* (1977) (discussing the rise of the modern business and its managers); ABA Committee on Corporate Laws, *Corporate Director's Guidebook*, 33 BUS. LAW. 1595 (1978) (providing an overview of the responsibilities and functions of corporate directors).

85. Institutional investors own approximately 50% to 60% of the total value of the stock of exchange-listed companies. See Lipton & Lorsch, *supra* note 84, at 60.

86. *Id.* at 61.

87. The mergers and acquisitions were often highly leveraged transactions in which the corporation assumed debt. The creditors, primarily holders of investment-grade bonds in the public markets, suffered tremendous losses from these transactions. In many leveraged buyouts, investment-grade debt was converted overnight into junk bonds with immediate market loss. John J. Creedon, *A Business Lawyer Reminisces*, 48 BUS. LAW. 335, 344-47 (1992). Creedon argues that "a board of directors of large, publicly held corporations had responsibilities beyond the immediate gratification of shareholder wealth." *Id.* at 346. See generally *Paramount Communications v. Time, Inc.*, 571 A.2d 1140 (Del. 1989) (holding no duty of directors to maximize share value when corporation dissolution is not inevitable); JAMES B. STEWART, *DEN OF THIEVES* (1991) (discussing the history of junk bond financing in the 1980s).

88. See Henn & Alexander, *supra* note 82, at 611; William J. Carney, *Does Defining Constituencies Matter?*, 59 U. CIN. L. REV. 385, 385 (1990) (indicating that constituency representation would not significantly affect corporate behavior); ABA Committee on Corporate Laws, *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253 (1990) [hereinafter ABA, *Other Constituencies*] (concluding that other constituencies statutes should not be part of the Revised Model Business Corporations Act); John V. Coates IV, Note, *State Takeover Statutes and Corporate Theory: The Revival of an Old Debate*, 64 N.Y.U. L. REV. 806 (1989) (discussing current unsettled meaning of "corporation").

89. See Symposium, *Corporate Malaise—Stakeholder Statutes: Cause or Cure?*, 21 STETSON L. REV. 1 (1991). See also ABA, *Other Constituencies*, *supra* note 88, at 2261-63.



emerging in corporate law in the 1990s is whether directors of corporations owe a duty to shareholders alone or to a broader constituency. Although the powers of the corporation are defined by state law, private sector corporations are subject to various federal laws, including securities, antitrust, environmental protection, taxation, and bankruptcy statutes. These federal statutes incorporate some of the interests of the broader corporate community.<sup>90</sup>

## B. Federal Agencies

An administrative agency is a governmental authority, other than a court or legislative body, which affects the rights of private parties. They are the government's machinery for carrying out congressional or executive programs with the force of law.<sup>91</sup> The agencies have authority to operate through adjudicating, rulemaking, investigating, prosecuting, and negotiating.<sup>92</sup>

The instruments that create agencies generally define their principal powers and duties. Congress confers administrative power to agencies, granting them discretion in carrying out Congressional goals and standards.<sup>93</sup> Most agency action is informal, grounded in the agency's discretionary authority.<sup>94</sup> The agency, however, must not exercise this discretionary authority in an arbitrary or capricious manner.<sup>95</sup> The Supreme Court has stated that an agency acts "arbitrarily and capriciously" when it fails to consider relevant factors and there is a clear

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90. The securities laws protect the public through registration, disclosure, and antifraud measures. A corporation may seek protection from its creditors under federal bankruptcy laws through either liquidation or reorganization. By permitting reorganization, Congress recognized that the assets of a debtor would be more valuable if used in a rehabilitated business than if "sold for scrap" in liquidation. See *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 203 (1983). The Bankruptcy Code recognizes creditors by giving them a voice in the debtor's reorganization. Under Chapter 11 reorganization, a committee of unsecured creditors votes on a plan of reorganization and can be heard on any issue. See GEORGE M. TREISTER ET AL., *FUNDAMENTALS OF BANKRUPTCY LAW* § 9.02(e), at 349-50 (1988).

91. Ronald C. Moe & Thomas H. Stanton, *Government-Sponsored Enterprises As Federal Instrumentalities: Reconciling Private Management with Public Accountability*, 49 PUB. ADMIN. REV. 321, 324 (1989).

92. KENNETH CULP DAVIS, *ADMINISTRATIVE LAW TEXT* 107-18 (3d ed. 1972).

93. *United States v. Shreveport Grain & Elevator Co.*, 287 U.S. 77, 85 (1932) ("[C]ongress may declare its will, and after fixing a primary standard, devolve upon administrative officers the 'power to fill up the details' by prescribing administrative rules and regulations.").

94. "A public officer has discretion whenever the effective limits of power leave him free to make a choice among possible courses of action or inaction." DAVIS, *supra* note 92, at 91.

95. Administrative Procedure Act, 5 U.S.C. § 706(2)(A) (1988).

error in judgment or the absence of any rational connection between the facts underlying the decision and the action taken.<sup>96</sup>

The agencies are subject to the Administrative Procedure Act,<sup>97</sup> its Freedom of Information requirements,<sup>98</sup> and the rulemaking procedures.<sup>99</sup> Claims against the agencies are governed by the Federal Tort Claim Act,<sup>100</sup> and agencies receive all funds from federal appropriations.

### C. Federal Instrumentalities

As hybrid governmental entities, enterprises have split personalities, combining both public and private characteristics. The law has dubbed these hybrids "federal instrumentalities."<sup>101</sup> Although privately owned, enterprises are granted authority by federal charter.

A federal instrumentality is a privately owned institution managed by private citizens, but supervised by the federal government. Under this dual authority structure, enterprises carry on profit-making business usually associated with private industry. However, they exist to fulfill the specific governmental purpose indicated in their federal charters.<sup>102</sup> In essence, the distinction between an agency and an instrumentality is that an instrumentality does not itself execute governmental policies, but instead facilitates their execution.

In the early 1800s the Supreme Court upheld Congress's authority to create private corporations through federal legislation.<sup>103</sup> After the War of 1812 left the nation's commercial and financial sectors in disarray, Congress chartered the Second Bank of the United States as a central bank to stabilize the national economy.<sup>104</sup> The Second Bank soon encountered hostility from state banks. Several states passed legislation

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96. *Citizens to Preserve Overton Park, Inc. v. Volpe*, 401 U.S. 402, 416 (1971) ("[T]he court must consider whether the decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment."); *see also Burlington Truck Lines, Inc. v. United States*, 371 U.S. 156, 166-68 (1962) (holding that the Interstate Commerce Commission's choice of remedy must be rational).

97. 5 U.S.C. §§ 551-559, 701-706, 1305, 1306, 3344, 6362, 7562.

98. 5 U.S.C. § 552.

99. 5 U.S.C. § 553.

100. 28 U.S.C. § 2671 (1993).

101. The term "federal instrumentalities" stems from the Supreme Court's reference in *Osborn* to "national instruments." *Osborn v. Bank of United States*, 22 U.S. (9 Wheat.) 738, 763 (1824).

102. A federal charter is analogous to a corporation's articles of incorporation. *See generally Moe & Stanton*, *supra* note 91, at 324.

103. *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 401-24 (1819); *Osborn*, 22 U.S. (9 Wheat.) at 861-64.

104. *See MALLOY*, *supra* note 9, at 16.

hindering its activities.<sup>105</sup> As part of the early controversy over federalism,<sup>106</sup> the Supreme Court in *McCulloch v. Maryland*<sup>107</sup> and *Osborn v. Bank of the United States*<sup>108</sup> upheld Congress's constitutional authority to charter the national bank as necessary and proper to carry out the fiscal operations of the government.<sup>109</sup> The Supreme Court found that the constitutional authority of the federal government was delegated by the people through representation in the Constitutional Convention.<sup>110</sup> This delegated authority consisted of enumerated federal powers which, although limited, were absolute within their spheres.<sup>111</sup> The Court reasoned that because the Constitution granted Congress authority to enact "necessary and proper" measures to execute the enumerated powers,<sup>112</sup> Congress had the power to create the Second Bank of the United States, even though power to do so was not expressly enumerated.<sup>113</sup> Under the rubric granting Congress the legislative authority to enact measures

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105. *Id.*

106. The 1791 charter of the Bank of the United States, which existed for 20 years, inspired the classic federalist debate between Alexander Hamilton and Thomas Jefferson. *Id.* at 8-17.

107. 17 U.S. (4 Wheat.) 316 (striking down a state statute taxing the Bank as unconstitutional).

108. 22 U.S. (9 Wheat.) 738 (reaffirming *McCulloch*).

109. *McCulloch* at 410-24; *Osborn* at 861-64.

110. *McCulloch* at 402-05.

111. *Id.* at 405. Early cases on federal instrumentalities, such as *McCulloch* and *Osborn*, concerned states' taxation of these entities. The state statutes were deemed unconstitutional because taxation implied the power to control the federal instrumentality, and hence the federal government. *McCulloch* at 425-37. Federal supremacy controls cases in which federal instrumentalities are granted explicit or incidental powers in conflict with state law. *See* First Nat'l Bank v. Missouri, 263 U.S. 640, 656 (1924). A more difficult question arises in the context of incidental powers. Absent explicit restrictions in their charters, federal instrumentalities exercise incidental powers when "there is a sufficiently close nexus between the State and the challenged action of the regulated entity so that the action of the latter may be fairly treated as that of the State itself." *Northrip v. Federal Nat'l Mortgage Ass'n*, 527 F.2d 23, 32 (6th Cir. 1975) (quoting *Jackson v. Metropolitan Edison Co.*, 419 U.S. 345, 351 (1974)) (test for state action), *cert. denied*, 444 U.S. 964 (1979); *see also* *Wahba v. New York Univ.*, 492 F.2d 96, 103 (2d Cir.) (test for state action), *cert. denied*, 419 U.S. 874 (1974); *Arnold Tours, Inc. v. Camp*, 472 F.2d 427, 432 (1st Cir. 1972) (holding that national bank travel agency operation was not within the bank's incidental powers); *Greene County Nat'l Farm Loan Ass'n v. Federal Land Bank*, 152 F.2d 215, 219 (6th Cir. 1945) (applying liberal construction to the authority of instrumentality to effectuate the purpose of its charter), *cert. denied*, 328 U.S. 834 (1946). On the other hand, when a state seeks to impose a condition by legislation—such as a procedural requirement in the banking industry—the focus shifts from the instrumentality to the statute in determining potential conflicts with federal law. *See, e.g.,* *Federal Nat'l Mortgage Ass'n v. Lefkowitz*, 390 F. Supp. 1364, 1368-71 (S.D.N.Y. 1975) (upholding state statute requiring Fannie Mae to pay interest on tax and insurance escrow accounts).

112. *McCulloch*, 17 U.S. (4 Wheat.) at 423-24.

113. *Id.* at 424-25. The Court found that the Constitution granted this power in the Necessary and Proper Clause. U.S. CONST. art. I, § 8, cl. 18.

"necessary" to the exercise of expressly enumerated powers, the Court enlarged federal power.

The Supreme Court recognized the benefits of the banks' private nature, stating that the corporate operations

enable the bank to render those services to the nation for which it was created, and are, therefore . . . national instruments. The business of the bank constitutes its capacity to perform its functions, as a machine for the money transactions of the government. Its corporate character is merely an incident, which enables it to transact that business more beneficially.<sup>114</sup>

Although the Court's underlying concern in *McCulloch* and *Osborn* lay in confronting attempts by the States to control the federal government, the cases are instructive because they define the legal basis for the existence of the federal instrumentalities. According to these Supreme Court cases, banks<sup>115</sup> and enterprises<sup>116</sup> have been defined as federal instrumentalities.

The federal instrumentalities are given explicit powers in their federal charters and incidental powers to carry out the explicit ones.<sup>117</sup> The chartering statutes, similar to private corporations' articles of incorporation, define the scope of authority granted to the instrumentalities.<sup>118</sup>

Enterprises resemble governmental agencies because of their federal charters, their underlying public policy purposes, the statutory limitations on the scope of their business, and their subjection to regulatory review.<sup>119</sup> Enterprises receive the benefits of some federal laws and are exempt from others. As instrumentalities of the federal government, en-

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114. *Osborn*, 22 U.S. (9 Wheat.) at 863.

115. See *First Nat'l Bank v. Missouri*, 263 U.S. 640, 656 (1924); *First Nat'l Bank v. Fellows*, 244 U.S. 416, 416 (1917); *Easton v. Iowa*, 188 U.S. 220, 229-30 (1903); *Davis v. Elmira Sav. Bank*, 161 U.S. 275, 283 (1896).

116. See, e.g., *Federal Land Bank v. Bismarck Lumber Co.*, 314 U.S. 95, 102 (1941); *Federal Land Bank v. Priddy*, 295 U.S. 229, 231, *reh'g denied*, 295 U.S. 769 (1935); *Smith v. Kansas City Title & Trust Co.*, 255 U.S. 180, 211-12 (1920) (Federal Land Banks and Joint Trust Land Banks); *Rust v. Johnson*, 597 F.2d 174, 178 (9th Cir. 1979); *Association of Data Processing Serv. Orgs., Inc. v. Federal Home Loan Bank Bd.*, 568 F.2d 478, 480 (6th Cir. 1977); *Northrip v. Federal Nat'l Mortgage Ass'n*, 527 F.2d 23, 30-33 (6th Cir. 1975), *cert. denied*, 444 U.S. 964 (1979); *Fahey v. O'Melveny & Myers*, 200 F.2d 420, 446 (9th Cir. 1952) (Federal Home Loan Bank).

117. *First Nat'l Bank v. Missouri*, 263 U.S. at 656.

118. *Id.* As the Court stated in *McCulloch*, the intent behind the Necessary and Proper Clause was to give Congress the discretion to legislate those means necessary to exercise its enumerated powers because a fixed set of powers would soon become outdated. *McCulloch*, 17 U.S. (4 Wheat.) at 420-21.

119. See generally Federal Housing Enterprises Financial Safety and Soundness Act of 1992, 12 U.S.C. § 4619 (Supp. IV 1992).

terprises are exempt from the Bankruptcy Code<sup>120</sup> and enjoy immunity under the Federal Tort Claims Act.<sup>121</sup> As private corporations, the instrumentalities are not subject to federal appointment of senior officers, civil service and federal procurement laws, the Freedom of Information Act,<sup>122</sup> or federal budgetary concerns. Nongovernmental or private classification of an instrumentality's activities also avoids the constitutional due process requirements applicable to the federal government.<sup>123</sup> However, several enterprises have lines of credit with the United States Treasury,<sup>124</sup> and although the enterprises are privately owned, their boards of directors include government-appointed directors.<sup>125</sup>

The enterprises generally do not receive government appropriations. Instead, the issuance of debt and mortgage-backed securities to private investors constitute their primary source of financing. The federal government, however, does *not* guarantee or back these securities.<sup>126</sup> Like Treasury securities, issues of enterprise debt and securities are approved by the Secretary of the Treasury, exempt from the Securities and Exchange Commission registration requirements, issued and paid through the Federal Reserve System, and enjoy an exemption from state and local taxation on their incomes.<sup>127</sup>

#### D. Implicit Federal Guarantee

Because enterprises, as federal instrumentalities, are similar to governmental agencies, the public perceives enterprise obligations and securities as backed by the federal government.<sup>128</sup> The fact that enterprises

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120. "Persons" who may file for bankruptcy under Chapters 7 or 11 of the Bankruptcy Code do not include "governmental units" or any other entities. 11 U.S.C. § 101(41) (Supp. III 1991). A "governmental unit" includes an instrumentality of the United States. 11 U.S.C. § 101(27). Therefore, the Bankruptcy Code does not apply to federal instrumentalities.

121. 28 U.S.C. § 2671 (1993).

122. 5 U.S.C. § 552 (1988 & Supp. III 1991).

123. See, e.g., *Roberts v. Cameron-Brown Co.*, 556 F.2d 356, 358-60 (5th Cir.), *reh'g denied*, 559 F.2d 1217 (5th Cir. 1977); *Fidelity Fin. Corp. v. Federal Home Loan Bank*, 589 F. Supp. 885, 896-97 (N.D. Cal. 1983), *aff'd*, 792 F.2d 1432 (9th Cir. 1986).

124. Federal Home Loan Bank has a \$4 billion line of credit; Federal National Mortgage Association has a \$2.25 billion line of credit; Federal Home Loan Mortgage Corporation has a \$2.25 billion line of credit; Federal Agricultural Mortgage Corporation has a \$1.5 billion line of credit; Student Loan Marketing Association has a line of credit of up to \$1 billion with the Treasury to purchase obligations. See GAO, PROFILES OF GOVERNMENT-SPONSORED ENTERPRISES, *supra* note 4, at 7.

125. Five out of 18 Fannie Mae and Freddie Mac directors and seven of Sallie Mae's 21 directors are appointed by the President of the United States. *Id.*

126. Debt obligations of the Financial Assistance Corporation are the sole exception. See *id.* at 43.

127. *Id.* at 7.

128. TREASURY REPORT, *supra* note 2, at 1.

are permitted to borrow in credit markets at interest rates only slightly higher than the Treasury and well below private corporate obligations supports this perception.<sup>129</sup>

In light of what is viewed as an "implicit federal guarantee" of enterprise debt,<sup>130</sup> many investors (both sophisticated and not) consider the securities extremely safe investments. Moody's and Standard and Poor's, private credit-rating agencies, have rated enterprise securities based on the strength of this implied government guarantee, in spite of the knowledge that no actual guarantee exists.<sup>131</sup> This perceived governmental guarantee has contributed to the exponential growth in volume of enterprise securities, in turn magnifying the potential cost of enterprise insolvency and forcing the government to consider taking an active role to prevent enterprise failure.

#### E. Too Big to Fail

"Too big to fail" describes the federal government's discretionary policy of keeping large, troubled institutions in operation when the cost of their failure would greatly exceed the cost of rescuing the institution.<sup>132</sup> Congress has therefore opted to bail out industries,<sup>133</sup> municipalities,<sup>134</sup> foreign debtors,<sup>135</sup> and financial institutions.<sup>136</sup> Financial

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129. GAO, PROFILES OF GOVERNMENT-SPONSORED ENTERPRISES, *supra* note 4, at 7.

130. See Stanton, *supra* note 21, at 153-66.

131. TREASURY REPORT, *supra* note 2, at B-13. The Report of the Secretary of the Treasury found that "[m]arket participants believe that, if [an enterprise] experiences extreme financial difficulties, Congress would step in to ensure that the debt holders and investors . . . would experience no losses." *Id.* at 8.

132. *Economic Implications of the "Too Big to Fail" Policy: Hearing Before the Economic Stabilization Subcomm. of the House Banking, Finance and Urban Affairs Comm.*, 102d Cong., 1st Sess. 4 (1991) [hereinafter *Hearing*] (referring to a statement of L. William Seidman, Chairman, Federal Deposit Insurance Corporation (FDIC)).

133. The Chrysler Corporation Loan Guarantee Act of 1979, Pub. L. No. 96-185, 93 Stat. 1324 (1980) (codified at 15 U.S.C. §§ 1861-75 (1988)); the Emergency Loan Guarantee Act of 1971, Pub. L. No. 92-70, 85 Stat. 178 (assistance to Lockheed Aircraft Corporation) (codified at 15 U.S.C. § 1841 (1988)); United States Railway Association Amendments Act of 1978, Pub. L. No. 95-565, 92 Stat. 2397 (codified at 45 U.S.C. 701 (1988)). See Block, *supra* note 3, at 952-53.

134. New York City Loan Guarantee Act of 1978, Pub. L. No. 95-339, 92 Stat. 460; New York City Seasonal Financing Act of 1975, Pub. L. No. 94-143, 89 Stat. 797.

135. In 1982, the United States government provided over \$5 billion in emergency assistance to Mexico. If Mexico had defaulted on its \$80 billion debt, the largest banks of America and Europe could have failed, resulting in worldwide economic panic. WILLIAM GREIDER, SECRETS OF THE TEMPLE: HOW THE FEDERAL RESERVE RUNS THE COUNTRY 517-20 (1987). See generally DARRELL DELAMAIDE, DEBT SHOCK: THE FULL STORY OF THE CREDIT CRISIS (1984) (illustrating how the actions of foreign debt affects the world capital markets).

136. The crisis caused by the failure of the nation's savings and loan institutions has

institutions, whether enterprises, banks, thrifts, insurance companies, brokerage firms, or pension funds, do not operate in isolation, but rather have significant interlocking ties and investments.<sup>137</sup> The failure of a large financial institution poses systemic risks to the economy because it would disrupt the markets for federal funds, government securities, mortgage-backed securities, and even foreign exchange.<sup>138</sup>

Much of the enterprises' success has arisen from the high level of interdependence between the national banking industry and the enterprises' secondary markets. The depository institutions participate in both the supply and the demand of the enterprises' business by originating loans as a primary lender, then selling the loans to the enterprises in exchange for mortgage-backed securities.<sup>139</sup> Nearly one trillion dollars in enterprise debt and equity held by institutional and individual investors worldwide trades regularly in the national markets.<sup>140</sup> By sheer transactional volume and access to new, untapped sectors of the economy, enterprises have made themselves an indispensable, if not vital, force to our nation's economic well-being.

For depository institutions, "too big to fail" means that the Federal Deposit Insurance Corporation (FDIC) elects to cover uninsured deposits in excess of the \$100,000 insurance cap.<sup>141</sup> The FDIC has discretion to invoke the "too big to fail" policy if it determines that the insolvent financial institution is "essential to the community."<sup>142</sup> The phrase "too big to fail" was coined in connection with the 1984 collapse of Continental Illinois National Bank, the first major bank failure in which the FDIC paid all depositors, even for accounts exceeding the \$100,000 insurance cap.<sup>143</sup> The FDIC covered Continental Illinois' uninsured deposits be-

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prompted one of the more dramatic, controversial, and expensive bailouts in American history. Block, *supra* note 3, at 952.

137. For example, banks lend to and invest in other banks; banks invest in foreign countries through currency and international loans; banks participate with other financial institutions to finance large projects; insurance companies and pension funds invest large sums in jumbo certificates of deposit. See generally GREIDER, *supra* note 135.

138. See *Hearing*, *supra* note 132, at 5 (statement of Robert L. Clark, Comptroller of the Currency, Office of the Comptroller of the Currency).

139. See Shenker & Colletta, *supra* note 27, at 1389.

140. GAO, A FRAMEWORK FOR LIMITING THE GOVERNMENT'S EXPOSURE TO RISKS, *supra* note 2, at 8.

141. 12 U.S.C. § 1821 (1988 & Supp. III. 1991).

142. 12 U.S.C. § 1823(c)(4)(G).

143. *Continental Illinois: How Bad Judgments and Big Egos Did It In*, WALL ST. J., July 30, 1984 at 1. See also Arthur E. Wilmarth, Jr., *Too Big To Fail, Too Few To Serve? The Potential Risk of Nationwide Banks*, 77 IOWA L. REV. 957 (1993).

By law the FDIC may liquidate a failed institution by paying the insured depositors, closing the bank's doors, and letting creditors (including the uninsured deposits) wait for a pro

cause of the extensive interdependence between Continental Illinois and thousands of national banks and because of the fear that its failure and liquidation would cause a ripple effect.<sup>144</sup> On a lower level, the government invokes the "too big to fail" policy through regulatory leniency, loans or advances to troubled institutions,<sup>145</sup> and sale of troubled institutions.<sup>146</sup>

Critics of the "too big to fail" policy have raised valid concerns regarding the inequitable treatment of small banks. In November of 1990, the FDIC closed and liquidated Freedom National Bank, a small minority-owned bank located in Harlem. Initially, the FDIC refused to pay \$11.1 million in deposits above the \$100,000 insurance cap. After much controversy, the FDIC paid Freedom's depositors fifty cents for each dollar of uninsured deposits.<sup>147</sup> But just two months later the FDIC closed the Bank of New England, a large regional bank, and chose to fully protect all uninsured depositors, at a cost of \$2 billion.<sup>148</sup>

As a result, a common perception developed that the government would always bail out larger institutions, market and consumer discipline declined, and poor management and risky investments went unchecked.<sup>149</sup> On the assumption that the Federal government would supply the safety net, management and shareholders were encouraged to take greater risks in order to reap the benefits of increased profitability. In the context of larger institutions, such behavior spelled a recipe for disaster. In 1991 Congress responded by limiting the FDIC's free-wheel-

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rata share of the remaining bank assets. Between 1985 and 1990, the FDIC protected over 99% of uninsured deposits in failed institutions. H.R. REP. NO. 330, 102d Cong., 1st Sess. 93 (1991), *reprinted in* 1991 U.S.C.C.A.N. 1901, 1906.

144. Approximately 2300 banks were large depositors in Continental Illinois. GREIDER, *supra* note 135, at 627. The FDIC had learned a costly lesson just two years earlier, when it liquidated Penn Square Bank, a bank made insolvent by risky lending practices. Although a relatively small midwestern bank, Penn Square had assigned \$1 billion of its loans to Continental Illinois. William Isaac, then Chairman of the FDIC, believed that a rescue of Penn Square Bank would tell other depository institutions "no matter what risks they take, the government will bail them out." *Id.* at 501. Continental Illinois's losses from the Penn Square Bank liquidation contributed significantly to its own failure two years later. *Id.*

145. When a bank gets into financial difficulty, it increases its borrowing at the Federal Reserve Discount Window. These advances have been criticized because the institution is allowed to delay its failure for an average of 10-12 months. During that time, the bank's capital depletes further and ultimately increases the FDIC's losses. *See* H.R. REP. NO. 330, 102d Cong., 1st Sess. 44 (1991), *reprinted in* 1991 U.S.C.C.A.N. 1901, 1907.

146. *See infra* Part V.

147. *See Hearing, supra* note 132, at 12.

148. *Id.* at 15.

149. *Id.* at 152.



ing use of the "too big to fail" policy to situations in which a bailout was least costly to the insurance fund.<sup>150</sup>

From an economic perspective, the massive size of enterprises and their importance to other financial institutions make them "too big to fail" because the resulting secondary markets are essential to the stability of our monetary policies. By facilitating credit, enterprises play a vital role in achieving housing, agricultural, and educational goals. Moreover, an enterprise's failure could have ripple effects, such as bank failures, economic turmoil, and disruption of social services.<sup>151</sup>

#### IV. The Congressional Response

##### A. The Reports

In the midst of channeling massive federal funding to rescue the thrift industry, Congress realized that enterprises could also pose a significant financial crisis. Thus Congress directed the Treasury Department and the General Accounting Office to study the financial safety and soundness of enterprises and to evaluate the federal government's exposure to risk from the enterprises' activities.<sup>152</sup> The Treasury Department found extremely thin capitalization among enterprises, but unlike other private sector corporations, the enterprises' ties to the government took them outside the scope of usual market-imposed discipline.<sup>153</sup> Both the Treasury and the General Accounting Office reported rapid enterprise growth during the 1980s. This growth was attributable to the dramatic expansion of Fannie Mae and Freddie Mac home-financing,<sup>154</sup> the prevailing market perception of government backing of enterprise obligations, and the lack of significant regulatory supervision.<sup>155</sup> The Treasury determined that the financial risks inherent in the enterprises posed systemic risks that were not susceptible to reduction through diversification or market discipline.<sup>156</sup>

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150. Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, §§ 141-143, 105 Stat. 2236, 2273-82 (codified in scattered sections of 12 U.S.C.).

151. A significant portion of enterprise securities are held by institutions covered by federal insurance. If these institutions became insolvent as a result of an enterprise's failure, the government would have to cover the federally insured accounts. GAO, *THE GOVERNMENT'S EXPOSURE TO RISKS*, *supra* note 5, at 94.

152. Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), § 1404, 103 Stat. 183, 551 (1989).

153. TREASURY REPORT, *supra* note 2, at 8.

154. *Id.* at 2-3. Between 1980 and 1989, enterprise securities outstanding grew at a 19.2% compounded rate from \$177 billion in 1980 to \$863 billion in 1989. *Id.*

155. *Id.*

156. *Id.*

The Treasury and the Government Accounting Office suggested that strong regulatory supervision would insure enterprise financial safety and soundness.<sup>157</sup> The Treasury further concluded that without initiation of effective government oversight, Congress should terminate all ties with the enterprises.<sup>158</sup>

#### B. 1992 Safety and Soundness Act

Congress responded on October 28, 1992, by passing the Federal Housing Enterprises Financial Safety and Soundness Act of 1992.<sup>159</sup> This Act increases regulatory supervision of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks, and explicitly states that the government does not guarantee enterprise debt.<sup>160</sup> The Act also intensifies the difficulties inherent in the enterprises' split personalities by reaffirming the enterprises' public policy objectives<sup>161</sup> and committing the government to an active role in the supervision of enterprise operations, while simultaneously attempting to distance the Treasury from liability.

The Safety and Soundness Act created the Office of Federal Housing Enterprise Oversight (Office of Oversight), a new regulator within the Department of Housing and Urban Development, to supervise the housing enterprises.<sup>162</sup> This new regulator, independent from the enterprises, possesses greatly strengthened regulatory powers within specific guidelines.<sup>163</sup> These provisions mirror legislation enacted in 1991 to strengthen the powers of the Federal Deposit Insurance Corporation (FDIC), requiring the regulators to take prompt action to enforce the laws.<sup>164</sup> The Safety and Soundness Act also requires minimum capital standards and specific agency action in the event of the undercapitalization of an enterprise, as it did with depository institutions.<sup>165</sup>

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157. *Id.* at 7-15; GAO, A FRAMEWORK FOR LIMITING THE GOVERNMENT'S EXPOSURE TO RISKS, *supra* note 2, at 4.

158. TREASURY REPORT, *supra* note 2, at 7.

159. Pub. L. No. 102-550, § 1301, 106 Stat. 3672, 3941 (codified at 12 U.S.C. § 4501 (Supp. IV 1992)).

160. 12 U.S.C. § 4503.

161. 12 U.S.C. § 4501. The Act requires enterprises to reaffirm their commitment to provide financing for low and moderate income families. *Id.*

162. 12 U.S.C. § 4511. The Federal Housing Finance Board remains responsible for the regulatory supervision of the Federal Home Loan Bank. *See supra* note 52.

163. *See generally* Safety and Soundness Act, 12 U.S.C. § 4513.

164. *See* Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, §§ 141-143, 105 Stat. 2236, 2273-82 (codified in scattered sections of 12 U.S.C.); *see also supra* note 150 and accompanying text.

165. 12 U.S.C. §§ 4611-4620.

The Safety and Soundness Act grants strong remedial powers to the Office of Oversight, including the power to appoint a conservator for an enterprise if it becomes critically undercapitalized.<sup>166</sup> In such a situation, the conservator operates or disposes of the enterprise as a going concern, restores the enterprise's soundness and solvency, or controls the enterprise's business in order to conserve its assets and property.<sup>167</sup> The Director of the Office of Oversight has discretionary authority to appoint a conservator for an enterprise with prior notice to Congress and the enterprise.<sup>168</sup> The enterprise has no statutory right to prevent the appointment and may only challenge it during a twenty-day period beginning upon appointment of the conservator by bringing an action for removal.<sup>169</sup> Even then, removal is premised upon a showing that the conservatorship decision was arbitrary, capricious, an abuse of discretion, or not otherwise in accordance with applicable law.<sup>170</sup>

Appointment power is discretionary to facilitate prompt regulatory action. These appointment powers strikingly resemble the powers of banking regulators to appoint a conservator or receiver for financially troubled banks and thrifts.<sup>171</sup> However, the omission of the power to appoint a receiver for enterprises reflects Congress's conclusion that the enterprises are indeed "too big to fail." The conservator's function in continuing to operate a business distinguishes it from a receiver who is charged with liquidation of the business.<sup>172</sup> In light of the parallels between the Safety and Soundness Act and the Federal Deposit Insurance Corporation Improvement Act of 1991, case law involving banking and thrift receivers and conservators is illustrative precedent for defining the powers of a conservator of an enterprise.

## V. Lessons from the Failed Banks and Thrifts

### A. Regulatory "Resolve"

The case law emerging from the banking and thrift crisis has consistently supported the government's policy of riding roughshod over the

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166. 12 U.S.C. § 4617.

167. 12 U.S.C. § 4620. *Cf.* 12 U.S.C. § 1821(d)(2)(D-E) (Supp. I 1989) (setting forth the FDIC's powers as conservator and receiver).

168. 12 U.S.C. § 4619(a)(3).

169. 12 U.S.C. § 4618(b)(1).

170. *Id.*

171. 12 U.S.C. § 1821(c).

172. The conservator of an enterprise succeeds to all the powers of its shareholders, officers, and directors. Safety and Soundness Act, § 12 U.S.C. § 4620. In the context of banks and thrifts, federal deposit insurance also confers the interests of the depositors upon the receiver or conservator. 12 U.S.C. § 1821(d)(2)(A)(i) (Supp. I 1989) (banks); 12 U.S.C. § 1464(d)(2)(E)(i) (Supp. III 1991) (savings associations).

interests of private parties. The government-appointed conservators and receivers possess "superpowers," which subject any person engaged in business with the financial institution to the loss of basic legal rights. Most notably, after the appointment of a conservator or receiver, the shareholders, creditors, and borrowers of the failed financial institutions suffer unexpected losses due to modification of their legal rights.

When a receiver or conservator is appointed for a federally insured bank or thrift, the federal regulator assumes the dual roles of receiver or conservator of the institution and insurer of deposits.<sup>173</sup> By law, the conservator or receiver steps into the shoes of the stockholders, officers, and directors of the failed institution.<sup>174</sup> The receiver is appointed to liquidate the institution and resolve its affairs. The conservator operates the institution as a going concern to restore the institution to a sound and safe condition. The interests of the FDIC, in its corporate capacity as insurer of deposits, are subrogated to the rights of the depositors. The receiver or conservator acts in tandem with the FDIC to "resolve" the failed institution in order to promote the stability of and confidence in the nation's banking industry.<sup>175</sup> The FDIC pays the insured deposits of the depository institution, and if the regulators determine that the failed institution is "too big to fail," the FDIC infuses additional funds to cover the uninsured deposits.<sup>176</sup>

To "resolve" the failed institution, the FDIC may choose to liquidate by paying off depositors and closing the institution. Liquidation is not the favored method because the sight of a closed bank diminishes confidence in the banking system.<sup>177</sup> Further, since liquidation freezes accounts and can cause depositors to face significant delays in recovering funds, liquidation disrupts the intricate financial machinery of the economy.<sup>178</sup>

To avoid these problems, the FDIC favors a "purchase and assumption" transaction in which it sells the failed institution to a solvent one, allowing reopening of the bank with no interruption and with no loss to depositors.<sup>179</sup> The acquiring institution receives the failed institution's assets and assumes all of its deposits (insured and uninsured).<sup>180</sup> The

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173. See *Federal Deposit Ins. Corp. v. Ashley*, 585 F.2d 157, 160 (6th Cir. 1978).

174. 12 U.S.C. § 1821(d)(2)(A); 12 U.S.C. § 1464(d)(2).

175. *Gunter v. Hutcheson*, 674 F.2d 862, 865-70 (11th Cir.), *cert. denied*, 459 U.S. 826 (1982).

176. *Id.* at 865.

177. *Id.*

178. *Id.*

179. *Id.*

180. *Id.*

FDIC, as corporate insurer, compensates the acquiring institution for the failed association's negative net worth—the difference between the purchased assets and the assumed liabilities (insured plus uninsured deposits).<sup>181</sup> The regulators try to complete the purchase and assumption quickly to avoid interruption in banking services.

## B. Shareholders

The shareholders of a failed financial institution subject to conservatorship lose their investment when the institution is deemed insolvent or unsafe to transact business. Loss of equity is a known business risk, but it is the shareholder's unexpected losses caused by governmental actions and allowed by an acquiescent judiciary that has shifted the benefits of corporate responsibility in the government's favor. First, as a regulator, the agency owes no duty to shareholders, even for negligent acts that may cause the institution financial problems.<sup>182</sup> Second, shareholders have no recourse to challenge the appointment of a conservator because of the complete judicial deference given to agency decisions.<sup>183</sup> Courts consistently have ignored shareholder claims that the appointment of a conservator constitutes a seizure of property without due process and have upheld such appointments.<sup>184</sup> Third, shareholders cannot rely on prior agreements with the regulators if these agreements are later rendered voidable for public policy reasons. Finally, several jurisdictions have permitted government-appointed conservators to stay shareholder claims against related third parties, granting the government priority in collection against those related third parties.<sup>185</sup> Collectively, these "superpowers" elevate government interests to a superior position, and allow courts to disregard shareholder rights and ban all shareholder redress against parties responsible for an institution's financial instability. The appointment of a conservator, in effect, nullifies all shareholder claims.

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181. See *Hearing*, *supra* note 132, at 152.

182. See *infra* notes 186-197 and accompanying text.

183. See *infra* notes 198-216 and accompanying text.

184. *Fahey v. Mallonee*, 332 U.S. 245, 253-56 (1947); *Franklin Sav. Ass'n v. Office of Thrift Supervision*, 934 F.2d 1127, 1136-37 (10th Cir. 1991), *cert. denied* 112 S. Ct. 1475 (1992); *First Fed. Sav. Bank & Trust v. Ryan*, 927 F.2d 1345, 1357-58 (6th Cir.) *cert. denied*, 112 S. Ct. 187 (1991); *Woods v. Federal Home Loan Bank Bd.*, 826 F.2d 1400, 1410-13 (5th Cir. 1987), *cert. denied*, 485 U.S. 959 (1988); *Biscayne Fed. Sav. & Loan Ass'n v. Fed. Home Loan Bank Bd.*, 720 F.2d 1499, 1503-05 (11th Cir. 1983), *cert. denied*, 467 U.S. 1215 (1984).

185. See *infra* notes 235-245 and accompanying text.

*(1) No Duty to Shareholders*

Regulators of an insured depository institution enjoy immunity from liability for negligent actions under the Federal Tort Claims Act (FTCA).<sup>186</sup> By denying such shareholder claims, the Supreme Court verified the absence of any duty to the institution<sup>187</sup> or its shareholders<sup>188</sup> owed by regulators exercising their broad supervisory discretion.<sup>189</sup> The "discretionary function" exception to the Federal Tort Claim Act<sup>190</sup> precludes claims based on an agency's performance or nonperformance of a discretionary function.<sup>191</sup> In the banking context, policy decisions to exercise agency powers, such as issuance of cease and desist orders or appointment of a conservator or receiver, rest solely within the discretion of the regulators and outside the scope of any judicial review.<sup>192</sup>

In *United States v. Gaubert*,<sup>193</sup> the Supreme Court applied the discretionary function exception to immunize agency negligence, leading to the insolvency of an insured financial institution. In the 1991 case, the

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186. *United States v. Gaubert*, 111 S. Ct. 1267 (1991).

187. *Federal Deposit Ins. Corp. v. Carter*, 701 F. Supp. 730, 735-37 (C.D. Cal. 1987). See also *In re Franklin Nat'l Bank Sec. Litig.*, 445 F. Supp. 723 (E.D.N.Y. 1978) (Franklin I); *In re Franklin Nat'l Bank Sec. Litig.*, 478 F. Supp. 210 (E.D.N.Y. 1979) (Franklin II) (holding regulatory agencies not liable absent a showing that they acted arbitrarily and capriciously, exceeded their regulatory authority, or actively managed the bank).

188. *Harmesen v. Smith*, 586 F.2d 156, 157 (9th Cir. 1978). Regulators have no duty to warn bank officers, directors, or depositors of irregularities found in examinations. *Emch v. United States*, 630 F.2d 523, 527-28 (7th Cir. 1980), *cert. denied*, 450 U.S. 966 (1981); *First State Bank v. United States*, 599 F.2d 558, 565 (3rd Cir. 1979), *cert. denied*, 44 U.S. 1013 (1980); *Davis v. Federal Deposit Ins. Corp.*, 369 F. Supp. 277, 280 (D. Colo. 1974).

189. *Gaubert*, 111 S. Ct. at 1275.

190. The discretionary function exception provides that the Government is not liable for: any claim based upon an act or omission of an employee of the Government, exercising due care, in the execution of a statute or regulation, whether or not such statute or regulation be valid, or based upon the exercise or performance or the failure to exercise or perform a discretionary function or duty on the part of a federal agency or employee of the Government, whether or not the discretion involved be abused. 28 U.S.C. § 2680(a) (1988).

191. Despite the statute's failure to define a "discretionary function," courts have generally immunized decisions based on social, economic, and political policy grounds. See *United States v. S.A. Empresa de Viacao Aerea Rio Grandense (Varig Airlines)*, 467 U.S. 797 (1984) (aircraft certification); *Indian Towing Co. v. United States*, 350 U.S. 61 (1955) (lighthouse maintenance); *Dalehite v. United States*, 346 U.S. 15 (1953) (fertilizing manufacture); *Federal Deposit Ins. Corp. v. Irwin*, 916 F.2d 1051 (5th Cir. 1990) (bank closure); *Ingham v. Eastern Air Lines, Inc.*, 373 F.2d 227 (2nd Cir.) (aircraft controller's reports), *cert. denied*, 389 U.S. 931 (1967).

192. *Carter*, 701 F. Supp. at 735-37; see also *Federal Deposit Ins. Corp. v. Jennings*, 615 F. Supp. 465 (W.D. Okla. 1985). Some courts have distinguished these policy decisions from routine operational governmental tasks. *Carter*, 701 F. Supp. at 734-36; see also cases cited *infra* note 207.

193. 111 S.Ct. 1267 (1991).

Supreme Court found that the Federal Home Loan Bank Board's negligent day-to-day involvement and supervision of a thrift fell within the discretionary function exception because the actions were attributable to the public policy decision to provide federal oversight of the industry.<sup>194</sup> The Supreme Court recognized that Congress had empowered banking regulators to supervise financial institutions in order to protect the insurance fund and had allowed them to decide when and how to supervise the financial institutions.<sup>195</sup> The Court stated that the regulators have the discretion to supervise through informal means as well as by invoking statutory sanctions.<sup>196</sup> For this reason, the Court determined that despite agency negligence, its actions necessarily involved the exercise of discretion in furtherance of the public policy goal of protecting the insurance fund; therefore, they were within the scope of federal government immunity.<sup>197</sup>

## (2) Challenging Conservatorship

The appointment of a conservator<sup>198</sup> for an insured depository institution signals the extinguishment of its equity value. Shareholders, faced with the loss of the past and future value of their equity, vigorously contest conservatorship as an unconstitutional deprivation of property with-

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194. *Id.* at 1277. The Supreme Court dismissed earlier decisions in which some courts classified the agency's assumption of ministerial or proprietary banking tasks—such as disposing of a failed bank's assets or the collection of debts—as falling outside the “discretionary function” exception of the FTCA. One court has set “the dividing line for the FDIC's negligence liability [as generally being] the date it assumes receivership of a bank.” *Carter*, 701 F. Supp. at 737. The court recognized that some of the FDIC's decisions after the imposition of the receiver will still be subject to the discretionary function exception. *Id.*

195. *Gaubert*, 111 S. Ct. at 1277-78.

196. *Id.* at 1277.

197. *Id.* at 1279-80. In another case, the government faced no liability for the consequences of its remedial measures as conservator. *Gibraltar Sav. v. Ryan*, 772 F. Supp. 1290 (D.D.C. 1991). In *Gibraltar*, the Office of Thrift Supervision replaced the acting conservator of a thrift with a receiver on insolvency. *Id.* at 1291. The association pointed to its solvency prior to the conservator's appointment, claiming that the insolvency was due to the conservator's actions. *Id.* at 1294. Gibraltar had invested substantially in fixed-rate, mortgage-backed securities, the market value of which declined because of a rise in interest rates. *Id.* at 1295. The conservator rejected the association's proposal to hedge the portfolio and liquidated it at a loss of \$229 million. *Id.* Although this loss contributed to Gibraltar's insolvency, the court stated that the conservator's failure to remedy the association's financial difficulties could not provide a basis for removing an otherwise properly appointed receiver. *Id.* See also *In re Conservatorship of Wellsville Nat'l Bank*, 407 F.2d 223 (3rd Cir.) (holding bank comptroller's decision that bank was insolvent not subject to review), *cert. denied*, 396 U.S. 832 (1969).

198. Federal law permits the appointment of a conservator or receiver for an insured depository institution. The discussion of the appointment of a conservator throughout this section also applies to the appointment of a receiver for a depository institution.

out due process of law.<sup>199</sup> Congress empowered the Director of the Office of Oversight with the discretion to appoint a conservator for Fannie Mae and Freddie Mac contingent on prior notice to Congress and the enterprise.<sup>200</sup> The courts have consistently upheld the *ex parte* appointments of conservators and receivers of banks and thrifts because of the overriding governmental interests in securing the financial stability of the banking industry and protecting insured deposits.<sup>201</sup> In 1947, the Supreme Court affirmed the constitutionality of the *ex parte* appointment without notice or predeprivation hearing for a federally chartered savings association.<sup>202</sup> The Court reasoned that because national associations are chartered by the federal government, they are consequently subject to its limitations.<sup>203</sup>

Recently, the Sixth Circuit affirmed the regulatory power to appoint banking conservators or receivers without prior notice or hearing because it furthered an important governmental interest—the safety of the banking system.<sup>204</sup> The Sixth Circuit noted that insolvency of an institution mandated prompt action and that the statutes authorizing such prompt action appropriately circumscribed agency authority to appoint conservators and receivers.<sup>205</sup> Accordingly, the Office of Oversight's

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199. U.S. CONST. amend. V, cl. 3.

200. Federal Housing Enterprises Financial Safety and Soundness Act of 1992, 12 U.S.C. § 4619 (Supp. IV 1992). Although the Director must give notice prior to the appointment of the conservator, this notice is merely a formality because the statute does not provide for either a waiting period or an opportunity for the enterprise to stop the appointment.

201. See cases cited *supra* note 184.

202. *Fahey v. Mallonee*, 332 U.S. 245, 256 (1947).

203. In *Fahey*, the Court rejected the shareholders' claim that the application of federal laws and regulations to the institution violated due process:

[I]t would be intolerable that the Congress should endow an association with the right to conduct a public banking business on certain limitations and that the Court at the behest of those who took advantage from the privilege should remove the limitations intended for public protection.

*Id.*

204. *First Fed. Sav. Bank & Trust v. Ryan*, 927 F.2d 1345, 1358 (6th Cir.), *cert. denied*, 112 S.Ct. 187 (1991).

205. *Id.* The court applied the three-prong test from *Fuentes v. Shevin*, 407 U.S. 67, 91 (1972), to determine when the government can seize property without prior hearing. *First Federal*, 927 F.2d at 1358. See also Christopher T. Curtis, *The Takings Clause and Regulatory Takeovers of Banks and Thrifts*, 27 HARV. J. ON LEGIS. 367 (1990) (indicating Congress and agencies can use their constitutional power to intervene and regulate economic activities without a taking). In *First Federal*, the Sixth Circuit determined that the association's remedy to sue for damages arising out of a wrongful appointment satisfied due process under the Fifth Amendment, thus eliminating any need for the judiciary to provide equitable relief. *First Federal*, 927 F.2d at 1358. The Sixth Circuit also rejected the association's claim that the appointment of a conservator or receiver without prior judicial review violates the provisions of Article III and stated that the appointment is an executive rather than a judicial power. *Id.* at 1359.



power to appoint a conservator for Fannie Mae or Freddie Mac would probably be upheld as constitutional since the enterprises were chartered by Congress and subject to the limitations of the statutes. The conservatorship would be deemed necessary to preserve the government's objective of improving the housing industry.

Agency decisions to appoint a conservator are generally not subject to judicial review prior to the actual appointment<sup>206</sup> because review would undermine the regulators' ability to minimize losses.<sup>207</sup> In furtherance of this policy, Congress specifically banned any judicial attempt to restrain or affect the exercise of the conservator's powers or functions.<sup>208</sup>

In the 1992 Safety and Soundness Act, Congress granted enterprises the right to challenge an appointment of a conservator through a postappointment action to remove the conservator.<sup>209</sup> Case law from bank and thrift actions shows that this removal action is difficult because courts defer to the agency decision.<sup>210</sup> The agency need only show, subject to review under the "arbitrary and capricious" standard, the existence of a

206. *American Bank, N.A. v. Clarke*, 933 F.2d 899 (10th Cir. 1991); *First Federal*, 927 F.2d at 1352-55. *But see* *Olympic Fed. Sav. & Loan Ass'n v. Office of Thrift Supervision*, 732 F. Supp. 1183, 1187-88 (D.D.C.), *appeal dismissed and remanded*, 903 F.2d 837 (D.C. Cir. 1990).

207. *See* *Telegraph Sav. & Loan Ass'n v. Schilling*, 703 F.2d 1019, 1025 (7th Cir.), *cert. denied*, 464 U.S. 992 (1983); *Shemonsky v. Office of Thrift Supervision*, 733 F. Supp. 892, 895 (M.D. Pa.), *aff'd*, 922 F.2d 833 (3rd Cir. 1990), *cert. denied*, 111 S. Ct. 1595 (1991). The association has the exclusive means of challenging the appointment of a conservator or receiver, though bank holding companies and majority shareholders have joined suit with associations in removal actions. *See* *Franklin Sav. Ass'n v. Office of Thrift Supervision*, 934 F.2d 1127 (10th Cir. 1991), *cert. denied*, 112 S. Ct. 1475 (1992); *Biscayne Fed. Sav. & Loan Ass'n v. Federal Home Loan Bank Bd.*, 720 F.2d 1499 (11th Cir. 1983), *cert. denied*, 467 U.S. 1215 (1984). When neither the association nor its parent company challenged the appointment of a receiver, shareholders of the parent company, acting in a derivative capacity, lacked standing to challenge the receiver. *FDIC v. American Bank Trust Shares*, 460 F. Supp. 549, 557-58 (D.S.C. 1979), *aff'd*, 629 F.2d 951 (4th Cir. 1980). Additionally, borrowers of a failed financial institution lack standing to question the validity of the appointment of a receiver or conservator. *See* *FDIC v. Marina*, 892 F.2d 1522, 1525-26 (11th Cir. 1990); *Shemonsky*, 733 F. Supp. at 892; *In re Liquidation of Am. City Bank & Trust Co., N.A.*, 402 F. Supp. 1229, 1231 (E.D. Wis. 1975); *Resolution Trust Corp. v. Commerce Partners*, 132 F.R.D. 443 (W.D. La. 1990).

208. 12 U.S.C. § 1464(d)(2)(D) (Supp. 1991); 12 U.S.C. § 203(b)(3) (Supp. 1991). Even while denying the prudence of an association's action to remove a conservator, courts cannot enjoin the sale of the assets of the association. *First Federal*, 927 F.2d at 1358; *Haralson v. Federal Home Loan Bank Bd.*, 837 F.2d 1123, 1125-26 (D.C. Cir. 1988). In *First Federal*, the Sixth Circuit refused to enjoin the regulator's "draconian" practice of appointing the receiver on a Friday, executing a sale of the association over the weekend, and opening the institution under its purchaser's name on Monday. *First Federal*, 927 F.2d at 1358.

209. Federal Housing Enterprises Financial Safety and Soundness Act of 1992, 12 U.S.C. § 4619 (Supp. IV 1992).

210. *See* *American Bank, N.A. v. Clarke*, 933 F.2d at 902-04.

statutory ground for the appointment.<sup>211</sup> In the face of increasing numbers of bank and thrift failures during the 1980s, the courts construed the limits of judicial review to negate virtually any possibility of removing a conservator or receiver.<sup>212</sup>

A court will remove a conservator or receiver only if no statutory ground for appointment exists.<sup>213</sup> However, despite statutory language that provides for consideration "upon the merits,"<sup>214</sup> evidence is restricted to the agency's administrative record. This presumption of correctness renders the underlying wisdom of the agency's decision

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211. Administrative Procedure Act, 5 U.S.C. § 706 (1946). Whether an agency acts arbitrarily or capriciously depends upon the amount of discretion afforded to the agency by statute. *Lincoln Sav. & Loan Ass'n v. Wall*, 743 F. Supp. 901, 904-05 (D.D.C. 1990). Congress granted the banking regulators considerable discretion and exclusive authority to appoint conservators and receivers in order to safeguard insured deposits. *Id.* at 905. Therefore, a request for removal under the arbitrary and capricious standard is denied simply upon a showing that the agency had the underlying facts when it acted, from which it could reasonably conclude that a statutory ground for the appointment existed. The courts grant even greater deference to the agency's decision based upon technical indices, such as unacceptable levels of high risk assets, unacceptable levels of liabilities, accounting standards, level of loan loss reserves, and predictions of future losses. *Franklin Sav. Ass'n*, 934 F. 2d at 1148. The Eleventh Circuit upheld the appointment of a receiver notwithstanding arbitrary and capricious conduct by the Federal Home Loan Bank Board. *Biscayne Fed. Sav. & Loan Ass'n*, 720 F.2d at 1504. Citing the broad grant of powers to banking regulators, the Eleventh Circuit expressly limited its review to the existence of a statutory ground for the appointment and explicitly banned consideration of the regulators' conduct. *Id.* at 1505.

212. Even when district courts granted relief to associations in the most egregious situations, appellate courts uniformly reversed those decisions. *Franklin Sav. Ass'n*, 934 F.2d at 1127; *Biscayne Fed. Sav. & Loan Ass'n*, 720 F.2d at 1502-05; *Fidelity Sav. & Loan Ass'n v. Federal Home Loan Bank Bd.*, 689 F.2d 803 (9th Cir. 1982).

213. *Biscayne Fed. Sav. & Loan Ass'n*, 720 F.2d at 1502-05.

214. *Id.* The scope of judicial review refers to evidence the court will examine in reviewing agency decisions. The standard of review refers to how the reviewing court will examine the evidence. *Franklin Sav. Ass'n*, 934 F.2d at 1136. In *Franklin Savings* the Tenth Circuit confined the scope of review of appointment decisions to the administrative record in accord with the Administrative Procedure Act. *Id.* at 1138. In removal actions, the agency must produce the documents which it relied upon in making its decision. The information must show a rational basis for the appointment. *Id.* at 1139. This restrictive standard precludes associations from introducing banking matters. The Tenth Circuit acknowledged that the reviewing court may go beyond the administrative record in limited circumstances to determine, for example, whether the record fails to disclose the factors considered by the agency or whether the agency considered all relevant factors including evidence contrary to the agency's position. *Id.* The Supreme Court has allowed the administrative record to be supplemented with oral testimony of administrative officials explaining their action. *Citizens To Preserve Overton Park, Inc. v. Volpe*, 400 U.S. 939 (1970). However, the Supreme Court strongly discouraged inquiry into the mental processes of administrative decisions and limited these questions to occasions when there is clear showing of bad faith or wrongdoing. *Id.* See also *United States v. Morgan*, 313 U.S. 409 (1941); *Franklin Sav. Ass'n v. Ryan*, 922 F.2d 209, 211 (4th Cir. 1991).

irrelevant.<sup>215</sup> An association must demonstrate by a preponderance of evidence that the decision had no basis in fact or law.<sup>216</sup> Although the enterprise has the right to challenge the appointment of a conservator, the enterprise would face the same barriers as the banks and thrifts because the discretion to appoint the conservator lies completely with the Director of the Office of Oversight.

(3) *Fair Play or Unlawful Taking?: The Power to Ignore Prior Agreements*

During the 1980s, the Federal Savings and Loan Insurance Corporation (FSLIC)<sup>217</sup> did not have the money to absorb the costs of insolvent thrifts, and Congress and the Executive branch refused to acknowledge the problems inherent in the thrift industry.<sup>218</sup> Financially troubled thrifts with debt-laden balance sheets desperately needed liquidation or merger with solvent associations in order to stem losses. To urge mergers between healthy member thrifts and troubled associations, the FSLIC and the Federal Home Loan Bank Board (FHLBB)<sup>219</sup> created an accounting gimmick dubbed "supervisory goodwill."<sup>220</sup> The FHLBB allowed supervisory goodwill to be considered an asset of the acquiring institution equivalent to the negative net worth—assets minus liabilities—of the troubled association.<sup>221</sup> Normally, the acquiring institutions would have had negative net worth after acquiring the troubled thrift. Treating supervisory goodwill as an asset enabled the healthy thrifts to meet regulatory capital requirements.<sup>222</sup> The acquiring institution assumed the deposits of the failed institution, and the FHLBB permitted the acquiring association to amortize the supervisory goodwill for periods of up to forty years.<sup>223</sup> In this manner, the FSLIC avoided using insurance funds to compensate the acquiring association for the unprofitable merger.<sup>224</sup>

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215. *Franklin Sav. Ass'n*, 934 F.2d at 1135-36.

216. *Id.*

217. FSLIC insured the deposits of thrifts until 1989. See Federal Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), § 401, 103 Stat. at 354-57.

218. See *Transohio Sav. Bank v. Office of Thrift Supervision*, 967 F.2d 598, 601-04 (D.C. Cir. 1992).

219. The FHLBB regulated the thrifts until 1989. See FIRREA, § 401, 103 Stat. at 354-57.

220. See *Transohio*, 967 F.2d at 602.

221. See *Charter Fed. Sav. Bank v. Office of Thrift Supervision*, 976 F.2d 203, 205-06 (4th Cir. 1992).

222. *Id.* at 206.

223. *Id.* at 205-06.

224. See *Guaranty Fin. Servs., Inc. v. Ryan*, 928 F.2d 994 (11th Cir. 1991). Under these agreements, the regulator would "forbear" enforcing the minimal capital standards by considering the supervisory goodwill part of capital. *Id.* at 996.

Under the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA),<sup>225</sup> Congress increased the required minimum capital standards for thrifts, providing a transition rule that limited the amount of supervisory goodwill.<sup>226</sup> FIRREA provides that the inability of *any* thrift to maintain minimum capital standards is an unsafe and unsound practice—a statutory ground for conservatorship or receivership.<sup>227</sup> The Office of Thrift Supervision (OTS)<sup>228</sup> applied these new capital standards to *all* thrifts, even those with prior supervisory goodwill agreements.<sup>229</sup>

Several thrifts sued the OTS to enforce the supervisory goodwill agreements when the retraction of supervisory goodwill caused otherwise solvent thrifts to fall below the statutory minimum capital standards and thereby become subject to impending closure.<sup>230</sup> Even though several district courts initially ruled in favor of the associations,<sup>231</sup> courts of appeal have reversed the district courts, stating that FIRREA's new capital requirements supersede prior supervisory goodwill agreements.<sup>232</sup> The Eleventh Circuit determined that regulatory forbearance permitted the existence and amortization of supervisory goodwill as regulatory capital only for as long as the law allowing the forbearances remained intact.<sup>233</sup>

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225. Pub. L. No. 101-73, § 1404, 103 Stat. 183, 551 (1989).

226. *Id.* § 301, 103 Stat. at 303.

227. *Id.*

228. This agency was created to regulate the thrifts. See H.R. REP. 54(I), 101st Cong., 1st Sess. 106 (1990).

229. *Capital Adequacy*, OFFICE OF THRIFT SUPERVISION THRIFT BULLETIN, Jan. 9, 1990, at 38-2.

230. *Charter Fed. Sav. Bank v. Office of Thrift Supervision*, 976 F.2d 203 (4th Cir. 1992); *Transohio Sav. Bank v. Office of Thrift Supervision*, 967 F.2d 598 (D.C. Cir. 1992); *Security Sav. & Loan v. Office of Thrift Supervision*, 960 F.2d 1318 (5th Cir. 1992); *Far West Fed. Bank, S.B. v. Office of Thrift Supervision*, 951 F.2d 1093 (9th Cir. 1991); *Guaranty Fin. Servs., Inc. v. Ryan*, 928 F.2d 994 (11th Cir. 1991); *First Fed. Sav. Bank & Trust v. Ryan*, 927 F.2d 1345 (6th Cir. 1991); *Ensign Fin. Corp. v. FDIC*, 785 F. Supp. 391 (S.D.N.Y. 1992); *Hansen Sav. Bank v. Office of Thrift Supervision*, 758 F. Supp. 240 (D.N.J. 1991); *Sterling Sav. Ass'n v. Ryan*, 751 F. Supp. 871 (E.D. Wash. 1990); *Flagship Fed. Sav. Bank v. Wall*, 748 F. Supp. 742 (S.D. Cal. 1990).

231. A few district courts, determining that FIRREA did not abrogate the forbearance agreements, enjoined the OTS from applying the new capital standards. *Sterling Sav. Ass'n*, 751 F. Supp. at 881; *Hansen Sav. Bank*, 758 F. Supp. at 247. One district court took the position that a forbearance agreement was an integral part of a merger of institutions—so integral that its disregard by the OTS mandated rescission of the original transaction and restoration of the institution to its premerger state. *Charter Fed. Sav. Bank v. Office of Thrift Supervision*, 773 F. Supp. 809, 824-28 (W.D. Va. 1991), *rev'd*, 976 F.2d 203 (4th Cir. 1992).

232. *Far West Fed. Bank*, 951 F.2d at 1097-1100; *Guaranty Fin. Servs.*, 928 F.2d at 1003; *Franklin Fed. Sav. Bank v. Office of Thrift Supervision*, 927 F.2d 1332, 1338-41 (6th Cir. 1991).

233. *Guaranty Fin. Servs.*, 928 F.2d at 1001. Some Circuit Courts have implied that an action for taking in violation of the Fifth Amendment will provide remedy for the contractual

The supervisory goodwill problems call into question the enforceability of agency agreements if and when governmental policies change. As regulated entities, the enterprises must be entitled to rely on agency agreements.<sup>234</sup>

*(4) FDIC Priority Over Shareholder Actions*

Even after an insured depository institution closes, the FDIC and the institution's shareholders directly compete for the assets of the institution's affiliated third parties.<sup>235</sup> The officers, directors, attorneys, accountants, or other parties affiliated with the failed institution are liable to suit by the FDIC, as successor to the failed institution, if any of their actions or omissions contributed to the institution's failure.<sup>236</sup> Because the FDIC sues *as* the institution, shareholders may only assert nonderivative claims against affiliated parties.<sup>237</sup> The FDIC has recognized that the first to judgment or settlement will benefit from the affiliated parties'

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rights abrogation. In a case reaching the takings issue, the Claims Court determined that the government breached a supervisory goodwill agreement and is liable for damages, but has yet to rule on the appropriate measure of damages or restitution. *Winstar Corp. v. United States*, 25 Cl. Ct. 541, 547-49, 553 (1992); *see Statesman Sav. Holding Co. v. United States*, 26 Cl. Ct. 904 (1992).

234. The abrogation of the supervisory goodwill agreements threatens the enforceability of all agency agreements and arguably could be precedent for other agencies, such as the Environmental Protection Agency and the Securities Exchange Commission, to negative prior contracts.

235. *See* Federal Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), § 901, 103 Stat. at 446-50.

236. The FDIC, as receiver, succeeds to the rights of the institution—its stockholders, members, account holders, depositors, officers, directors, and assets. 12 U.S.C. § 1821(d)(2)(A) (Supp. 1991). The FDIC pays insured deposits of a failed institution, whether by liquidation or purchase and assumption. When it does so, the FDIC is subrogated to all rights of depositors against the institution by statute, and the FDIC as receiver assigns the institution's assets, including its causes of action, to the FDIC as insurer. 12 U.S.C. § 1821(g) (Supp. 1991); *see Gaff v. FDIC*, 919 F.2d 384, 385 n.1 (6th Cir. 1990); *see also Gunter v. Hutcheson*, 674 F.2d 862, 865-66 (11th Cir.), *cert. denied*, 459 U.S. 826 (1982). Accordingly, the FDIC has standing to bring suit against institution-affiliated third parties in both its receivership and corporate capacities.

237. Because Congress requires FIRREA to provide the exclusive remedy to claimants against an insolvent financial institution, shareholder recourse lies only in pursuing an administrative claim under either FIRREA or through another statutory structure entirely, such as RICO or the federal securities laws. Shareholders lack standing to assert derivative claims where their injuries are not direct and distinct from injury sustained by the corporation and the other shareholders. *See Rylewicz v. Beaton Servs., Ltd.*, 888 F.2d 1175, 1179 (7th Cir. 1989); *Sparling v. Hoffman Constr. Co.*, 864 F.2d 635, 640-41 (9th Cir. 1988); *Leach v. FDIC*, 860 F.2d 1266, 1273-74 (5th Cir. 1988), *cert. denied*, 491 U.S. 905 (1989); *Crocker v. FDIC*, 826 F.2d 347, 349 (5th Cir. 1987), *cert. denied*, 485 U.S. 905 (1988). Shareholders can only bring nonderivative claims against bank-related third parties because the right to the derivative action is held by the FDIC. *See FDIC v. Jenkins*, 888 F.2d 1537, 1538-39 (11th Cir. 1989). "A derivative action is one 'in which the right claimed by the shareholder is one the corpora-

larger pool of assets.<sup>238</sup> Consequently, the FDIC has vigorously asserted its entitlement to priority over shareholders and has endeavored to stay all shareholder actions pending resolution of its own claims.<sup>239</sup>

Circuit courts are split on the priority of the FDIC or shareholder.<sup>240</sup> Finding no congressional intent under the Federal Deposit Insurance Act<sup>241</sup> to create an absolute priority rule,<sup>242</sup> the Eleventh Circuit refused to fashion a common-law rule of FDIC priority.<sup>243</sup> By contrast, the Sixth Circuit rejected the Eleventh Circuit's analysis by creating a federal common-law rule of FDIC priority.<sup>244</sup> The Sixth Circuit distin-

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tion could itself have enforced in court.' " Howard v. Haddad, 916 F.2d 167, 189 (4th Cir. 1990) (quoting Daily Income Fund, Inc. v. Fox, 464 U.S. 523, 529 (1984)).

238. Claims by depositors and other creditors against bank-related third parties have been generally dismissed as derivative. See *In re Sunrise Sec. Litig.*, 916 F.2d 874, 889 (3d Cir. 1990); *Downriver Community Fed. Credit Union v. Penn Square Bank*, 879 F.2d 754, 764 (10th Cir. 1989), cert. denied, 493 U.S. 1070 (1990); *Brandenburg v. Seidel*, 859 F.2d 1179, 1191 (4th Cir. 1988); *Adato v. Kagan*, 599 F.2d 1111, 1117 (2d Cir. 1979) ("[I]ndividual depositors may sue in their own right [under banking laws] if they have suffered a wrong that is distinctly theirs and not common to all.").

239. *Gaff v. FDIC*, 919 F.2d 384, 396-97 (4th Cir. 1990), modified on reh'g, 933 F.2d 400 (1991) (granting FDIC priority); *Howard v. Haddad*, 916 F.2d 167, 170 (4th Cir. 1990) (rejecting FDIC priority); *FDIC v. Jenkins*, 888 F.2d 1537 (11th Cir. 1989) (rejecting FDIC priority).

240. See *supra* note 239.

241. 12 U.S.C. § 1811 (Supp. 1991).

242. The Eleventh Circuit noted that the conference committee rejected an FIRREA amendment to grant the FDIC priority. *Jenkins*, 888 F.2d at 1538 n.1. One Congressman explained that the rejected amendment had not received adequate attention by Congress and FDIC priority would undermine fraud enforcement and be unfair to private plaintiffs. 135 CONG. REC. H4985 (daily ed. Aug. 3, 1989) (statement of Rep. Glickman). The Securities and Exchange Commission (SEC) had filed an amicus brief in *Jenkins* to oppose the FDIC, arguing that the priority would be a disincentive to private fraud suits and would harm the SEC's enforcement scheme. *Jenkins*, 888 F.2d at 1540 n.5. The conference committee was aware of the SEC's opposition to FDIC priority, the amicus brief in *Jenkins*, and the SEC's argument that private actions are a necessary supplement to enforcement actions of the SEC and Department of Justice. 135 CONG. REC. H4985 (daily ed. Aug. 3, 1989) (statement of Rep. Glickman). See Samantha Evans, Note, *An FDIC Priority of Claims over Depository Institution Shareholders*, 41 DUKE L.J. 329, 359-64 (1991).

243. *Jenkins*, 888 F.2d at 1544-46. The *Jenkins* court distinguished the FDIC's priority from the bankruptcy principle that shareholders do not recover from the corporate assets until the general creditors' claims have been satisfied. *Id.* at 1545. The shareholders in *Jenkins* were not attempting to collect from assets of the bank, but against the assets of solvent third parties. *Id.*

244. *Gaff*, 919 F.2d at 388. The court recognized that federal law has consistently been applied to the FDIC when it operates in its corporate capacity. *Id.*; see *FDIC v. Leach*, 772 F.2d 1262, 1207-08 (6th Cir. 1985); *Gunter v. Hutcheson*, 674 F.2d 862, 869 (11th Cir.), cert. denied, 459 U.S. 826 (1982). Although reaching opposite rulings, both Circuits relied upon the Supreme Court's factors enunciated in *United States v. Kimbell Foods, Inc.*, 440 U.S. 715 (1979), to determine whether a uniform federal rule should be created. In *Kimbell*, the Supreme Court articulated three factors to assist courts in deciding whether a federal rule of law should displace state rules of commercial law. The Court defined the issues as follows: (1)

guished the corporate responsibility of banks from that of corporations by noting that the primary expectation of the national banks lay in preserving deposits, not in shareholder suits against officers and directors for fraud or mismanagement.<sup>245</sup> On this basis, the Sixth Circuit determined that a federal rule granting FDIC priority over shareholder claims against third parties would not defeat commercial expectations under state law.<sup>246</sup>

Whether the FDIC would have priority over other private party claims against common defendants is even more significant in the context of enterprises because an enterprise's business is to buy and sell securities through the secondary market.<sup>247</sup> As with banks and thrifts, if the conservator of an enterprise were to step into the shoes of the institution and be entitled to bring suit against third parties on behalf of the enterprise, then private parties would be limited to nonderivative actions.

The key distinction between banks and enterprises on this issue is that enterprises are exempt from federal securities laws. Banks' securities, offered through private payments, public offerings, or the public stock market, are subject to scrutiny under federal securities laws and regulations.<sup>248</sup> Housing enterprises offer their securities nationwide in a market that is second in size only to the market for U.S. Treasury obligations.<sup>249</sup> These enterprise securities have been exempted from the securities laws. As a result, private parties purchasing enterprise obligations have little protection against fraud or mismanagement. FDIC priority over private-party suits against related third parties after the appointment of a conservator would diminish the value of the enterprise's obligations and devalue the financial status of the entities owning these obligations. FDIC priority would further disrupt the commercial expectations of investors.

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whether the program needs national uniformity, *id.* at 728; (2) whether the application of state law would frustrate specific objectives of the federal program, *id.*; and (3) whether the application of a federal rule of common law would frustrate settled commercial practices predicated on state law, *id.* at 729. The Sixth Circuit found that the bank insurance system required national uniformity and could not meet statutory objectives if subjected to varying state laws. *Gaff*, 919 F.2d at 389.

245. *Id.*

246. *Id.* at 390.

247. As of 1989, Fannie Mae reported \$116.1 billion in debt outstanding, and Freddie Mac had issued \$272.9 billion in mortgage-backed securities. See TREASURY REPORT, *supra* note 2, at A-8 (for Fannie Mae) and B-37 (for Freddie Mac).

248. 12 U.S.C. § 24 (Supp. VII 1993).

249. GAO, PROFILES OF GOVERNMENT-SPONSORED ENTERPRISES, *supra* note 4, at 26.

## C. Creditors

### (1) *Prudential Mootness*

Creditors<sup>250</sup> of an insolvent bank or thrift have difficulty collecting claims against the failed institution. They are entitled to receive the liquidated value of their claim.<sup>251</sup> However, the courts tolerate unequal treatment of creditors.<sup>252</sup> When a receiver is appointed for a failed bank or thrift, the receiver values the institution's assets and liabilities. If liabilities exceed assets, creditors' claims are deemed "worthless."<sup>253</sup> Once the "worthless" determination has been made, the receiver has complete discretion to pay some creditors or give others nothing.<sup>254</sup>

When a troubled institution is transferred by a purchase and assumption agreement, the acquiring bank assumes the failed bank's deposits, but might not assume other liabilities, thus leaving some creditors with the failed bank.<sup>255</sup> The regulators transfer the assets of the failed institution to the acquiring institution. In this transfer, the creditors are not assumed by the acquiring institution, but remain creditors of the worthless receivership estate.<sup>256</sup> The Fifth Circuit upheld the regulators' determination that these unsecured creditors' claims were worthless when the failed financial institution's assets were insufficient to cover deposits and secured creditors.<sup>257</sup> Accordingly, the claims of unsecured creditors were deemed moot as the liquidation value of the claims was zero.<sup>258</sup> Since there is no practical purpose in adjudicating the merits of these claims, courts can dismiss creditor claims based upon "prudential mootness."<sup>259</sup>

### (2) *Affiliated Creditors*

To recover for the losses of one failed subsidiary, federal regulators can reach the assets of bank holding companies<sup>260</sup> and their subsidiaries.

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250. The term "creditors" as used in this section excludes the insured depositors.

251. 12 U.S.C. § 1821(i)(2) (Supp. 1991); see *Texas Am. Bancshares, Inc. v. Clarke*, 954 F.2d 329, 340 (5th Cir. 1992).

252. *Texas Am. Bancshares*, 954 F.2d at 329.

253. See *Gulley v. Sunbelt Sav. F.S.B.*, 902 F.2d 348, 356 (5th Cir. 1990).

254. See *Texas Am. Bancshares*, 954 F.2d at 329.

255. *Gunter v. Hutcheson*, 674 F.2d 862, 869 (11th Cir. 1982).

256. *Gulley*, 902 F.2d at 357 (federal regulatory transactions not subject to state fraudulent conveyance laws).

257. *Id.* at 356.

258. *Id.*

259. *First Indiana Fed. Sav. Bank v. FDIC*, 964 F.2d 503, 506-07 (5th Cir. 1992); 281-300 *Joint Venture v. Onion*, 938 F.2d 35, 38 (5th Cir. 1992).

260. A bank holding company is any company that controls either a bank or another company that itself controls a bank. 12 U.S.C. § 1841(a) (1988).



Several bank holding companies have challenged the Comptroller of Currency and the FDIC on the grounds that closing *all* of the holding companies' subsidiary banks when only one or more of the subsidiaries have failed violates the National Bank Act.<sup>261</sup> Thereby, the holding companies do not merely lose the weak subsidiary banks, but all subsidiary banks share the cost of resolving the financial problems of any other subsidiary.<sup>262</sup>

The typical scenario that leads to the insolvency and closure of banks is as follows: The weakest subsidiary has borrowed heavily from its affiliated subsidiaries and from other nonaffiliated institutions through federal funds or unsecured debt. Upon appointment of a receiver for the insolvent subsidiary, the FDIC pays the nonaffiliated debts at face value, but devalues the affiliated debt to liquidation value. In turn, these losses incurred by the affiliated creditors—the difference between the full value and the liquidation value of the debt—make the subsidiary insolvent. Then, through a domino effect, the Comptroller closes the other affiliated institutions.<sup>263</sup> This scheme enables the FDIC to sell the holding company's banking system as a whole through purchase and assumption transactions.

In *Texas American Bancshares, Inc. v. Clarke*, the Fifth Circuit upheld the regulators' actions, stating that the law merely required creditors to be paid the liquidation value of their claim, and that the FDIC's additional payments to creditors was discretionary.<sup>264</sup> However, the conservator or receiver of a bank or thrift must pay the creditors at least the liquidation value of their claims, and has discretion to pay some creditors more. In an enterprise, the creditors are the persons and institutions holding mortgage-backed securities and other enterprise obligations. A conservator of an enterprise treats creditors differently than the banks and thrifts. The conservator of an enterprise is not required to pay creditors the liquidation value of their claims, but must treat all similarly situated creditors in the same manner.

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261. *Texas Am. Bancshares, Inc. v. Clarke*, 954 F.2d 329, 334-35 (5th Cir. 1992); *First Empire Bank-New York v. FDIC*, 572 F.2d 1361, 1369-71 (9th Cir. 1978); *M Corp v. Clarke*, 755 F. Supp. 1402, 1408, 1422-23 (N.D. Tex. 1991); *Senior Unsecured Creditors Comm. of First Republic Bank Corp. v. FDIC*, 749 F. Supp. 758, 768-71 (N.D. Tex. 1990).

262. *See M Corp.*, 755 F. Supp. at 1408, 1422-23.

263. *Texas Am. Bancshares*, 954 F.2d at 329, 333-34. Thirteen subsidiaries were deemed insolvent when the FDIC agreed to pay only 67% of the face amount of the obligations owed by the bank holding company. The subsidiaries would have remained solvent if the FDIC had paid the full amounts due. *Id.* at 332, 335.

264. *Id.* at 335-36. *But see First Empire Bank*, 572 F.2d at 1370-71 (requiring equitable treatment for all creditors based on pre-FIRREA legislation).

## D. Borrowers

In expanding the protection of federal deposit insurers, Congress and the courts have barred borrowers, as successors to the failed bank, from bringing state-law defenses against the regulators.<sup>265</sup> The Supreme Court originated this doctrine in 1942 in *D'Oench, Duhme & Co. v. FDIC*,<sup>266</sup> as a modification of the doctrine of equitable estoppel.<sup>267</sup> In *D'Oench, Duhme*, the Supreme Court did not allow a borrower to enforce a secret side agreement to a promissory note when the agreement was designed to deceive the FDIC.<sup>268</sup> In the side agreement, the defunct bank agreed not to collect under the note.<sup>269</sup> The Court determined that such agreements conceal the truth from bank examiners, and therefore the borrower was estopped from asserting any defense.<sup>270</sup>

In 1950 Congress partially codified *D'Oench, Duhme* in 12 U.S.C. § 1823(e) to provide that when the FDIC acquires a loan, in its corporate capacity, the only documents operative between the borrower and the FDIC are written agreements executed by the bank and the obligor and approved by the bank's board of directors, which have been in the bank's continuous official record.<sup>271</sup> *D'Oench, Duhme* and § 1823(e) have been broadly interpreted to grant "holder in due course"<sup>272</sup> status to the FDIC holder.<sup>273</sup> For instance, the Eleventh Circuit found that "the FDIC has a complete defense to state and common law fraud claims on a

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265. Marsha Hymanson, Note, *Borrower Beware: D'Oench, Duhme and Section 1823 Overprotect the Insurer When Banks Fail*, 62 S. CAL. L. REV. 255, 255 (1988).

266. 315 U.S. 447 (1942).

267. The elements to establish equitable estoppel are (1) the estopped party makes false or misleading representations by words, conduct, or silence, (2) the other party relies upon that communication, and (3) the other party would be harmed materially if the estopped party is later permitted to assert any claim inconsistent with the earlier conduct. DAN B. DOBBS, HANDBOOK ON THE LAW OF REMEDIES § 2.3, at 42 (1973).

268. *D'Oench, Duhme*, 315 U.S. at 459-60. It is unnecessary to show actual intent by the borrower to deceive the bank examiners. The only requirement is that the borrower participated in the act bringing about the deception. *Id.* at 461. See generally Robert W. Norcross, Jr., *The Bank Insolvency Game: FDIC Superpowers, the D'Oench Doctrine, and Federal Common Law*, 103 BANKING L.J. 316 (1986) (describing modern application of the *D'Oench* doctrine).

269. *D'Oench, Duhme*, 315 U.S. at 459-61.

270. *Id.* The *D'Oench* doctrine applies to the FDIC in both its receiver and corporate capacities. See *FDIC v. McClanahan*, 795 F.2d 512, 516 (5th Cir. 1986).

271. 12 U.S.C. § 1823(e) (Supp. IV 1992). For a discussion of legislative history, see Hymanson, *supra* note 265, at 275-80.

272. "Holders in due course" are not subject to personal defenses that the makers of negotiable instruments may have against the original holder. U.C.C. § 3-407.

273. *FDIC v. Wood*, 758 F.2d 156, 159 (6th Cir.), *cert. denied*, 474 U.S. 944 (1985); *Gunter v. Hutcheson*, 674 F.2d 862, 873 (11th Cir. 1982); *FDIC v. Burger*, 631 F. Supp. 1141, 1144 (D. Kan. 1986); *FDIC v. Rockelman*, 460 F. Supp. 999, 1003 (E.D. Wis. 1978).

note acquired by the FDIC . . . for value, in good faith, and without actual knowledge of the fraud."<sup>274</sup>

The most expansive modification to *D'Oench, Duhme* came from the Supreme Court in 1987. In *Langley v. FDIC*,<sup>275</sup> the Court granted the FDIC super "holder in due course" status, thus eliminating lender liability claims. The borrowers in *Langley* defended a collection action alleging that the notes had been procured by the bank through misrepresentation and fraud.<sup>276</sup> But since the loan documents did not refer to the bank's misrepresentations, the Supreme Court determined that they could not be asserted as a defense against the FDIC under § 1823(e).<sup>277</sup> Justice Scalia, writing for the majority, stated that the word "agreement" in § 1823(e) is not limited to an express promise to perform an act in the future.<sup>278</sup> Justice Scalia reiterated that the purpose of § 1823(e) is to allow federal and state bank examiners to rely on bank records in evaluating a bank's assets, and so that "agreements" become bank records contemporaneously with the making of the note, subject to approval by the bank's board to prevent fraudulent insertion of new terms.<sup>279</sup> The Supreme Court further stated that FDIC knowledge of the asserted defense at the time it acquired the note was irrelevant.<sup>280</sup>

So, after *Langley*, the FDIC has super holder in due course status, which allows it to ignore defenses about which it had prior knowledge.<sup>281</sup> The initial concepts of equitable estoppel espoused in *D'Oench, Duhme* are sound, but the expansion of these principals granting the FDIC super holder in due course status is unfair to innocent borrowers. The purchase of notes and mortgages from the primary lenders gives the enterprises holder in due course status. *D'Oench, Duhme* superpowers give the conservator an unfair advantage over innocent, victimized borrowers and only serve to disrupt the borrowers' commercial expectations.

Every private party engaged in business with the failed banks and thrifts risks unexpected losses due to modification of legal rights. The banking and thrift crisis was the first federal bailout of federal instrumentalities in which the private parties contested government actions.

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274. *Gunter*, 674 F.2d at 873.

275. 484 U.S. 86 (1987).

276. *FDIC v. Langley*, 792 F.2d 541, 543 (5th Cir. 1986), *aff'd*, 484 U.S. 86 (1987)

277. *Langley*, 484 U.S. at 86.

278. *Id.* at 90-92.

279. *Id.* at 92. Justice Scalia acknowledged that fraud in fact which renders the agreement entirely void would take the instrument out of § 1823(e). *Id.* at 93.

280. *Id.*

281. The estoppel protection of *D'Oench, Duhme*, § 1823(e), and the holder in due course doctrine have been extended to private purchasers of a failed financial institution.

Through the regulator's actions and the court's acquiescence a new standard evolved, under which the government's interests superseded those of the private sector.

## VI. Reorganization: Balancing Private and Public Interests

### A. Enterprises Distinguished From Banks and Thrifts

Banks, thrifts and enterprises, as congressionally chartered, privately owned corporations, share federal instrumentality status. The principle difference between banks and enterprises is that federal banking laws were created to protect depositors, while enterprises were chartered to benefit borrowers. Accordingly, the regulatory response to the banking and thrift crisis protected the depositors, but sacrificed the institutions and other private-sector interests. It created a new standard of corporate governance in which the government's interests superseded those of the shareholders, creditors, and borrowers.<sup>282</sup> Federal deposit insurance is essential to the business of banking, but it is not the only important element in the industry. Shareholder investment is vital to raise capital; creditors and borrowers keep the institution viable on a daily basis. While the depositors of a failed bank or thrift must be protected, the iron-clad retroactive grant of power to the government caused the closure of viable institutions and prevented shareholders and creditors from protecting their investments. This new standard favoring the government disregards other vital interests and is misplaced in connection with banks and thrifts. It would also be wrong to apply it to an enterprise.

Although not explicitly insured by the federal government, enterprise debts must be honored by the government because of the important role they play in the nation's financial markets. Congress chartered enterprises to promote and facilitate social goals, but the enterprises have become indispensable to the American economy because of the extraordinary growth of the secondary markets.<sup>283</sup> Enterprises are indeed "too big to fail."<sup>284</sup> Like the Latin American debt crisis, the farm credit rescue, and the bank and thrift debacle, the failure of an enterprise would harm the national and international financial markets. The federal government would need to act quickly to support the continued operation of enterprises.

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282. See *supra* notes 265-281 and accompanying text.

283. The obligations of the enterprises more than doubled in the five years from 1984 to 1989. GAO, *THE GOVERNMENT'S EXPOSURE TO RISKS*, *supra* note 5, at 28.

284. See Robin Paul Malloy, *The Secondary Mortgage Market—A Catalyst for Change in Real Estate Transactions*, 39 Sw. L.J. 991 (1986).

Congress created enterprises to protect borrowers by improving the supply of credit. As financial intermediaries, enterprises must also protect their shareholders and creditors to fulfill their public mission of enhancing and stabilizing the availability of loans. Without adequate precautions, laws granting "superpowers" to the conservators of the failed depository institutions could be precedent for the same damaging grant of power to the conservator of an enterprise. As financial institutions, the enterprises have strong structural similarities to banks and thrifts, and similarly do business in the private sector with shareholders, creditors, and borrowers.

However, there are two key distinctions between enterprises and banks or thrifts. First, policy motivations behind the bank and thrift industry mandate closure of institutions facing economic hardship, while different goals for the enterprises require continued operation, even in crisis situations. Shaped by the Great Depression and the fear of a "run on the bank," the FDIC promotes the stability of and confidence in the nation's banking industry by supporting depositors with insurance backed by the full faith and credit of the United States Treasury.<sup>285</sup> Thus, the regulators were obligated to protect the depositors in the bank and thrift crisis by closing and merging the banks and thrifts, at the expense of other interests. Although the enterprises also originate from the Great Depression, they were created to benefit borrowers by enhancing the stability and availability of credit. In the Safety and Soundness Act of 1992, Congress recognized that the enterprise function of providing credit could only be advanced by sustaining the ongoing business of the enterprises. The second distinction is that closure of banks and thrifts would primarily affect regional markets, but the enterprise failure could disrupt national and international markets. The banks and thrifts remain primarily regional institutions whose operations can be absorbed by other institutions. But since the enterprises are national financial institutions that control secondary markets affecting borrowers nationally and investors worldwide, the government would have great difficulty "resolving" a financially troubled enterprise by merging it into another enterprise.

A government-appointed conservator of an enterprise would create more problems than it would solve. The conservator should be accountable to the shareholders of an enterprise and should not be entitled to priority for suits against common third-party defendants. Because enterprise stock offerings and debt obligations are exempt from securities laws,

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285. *Gunter v. Hutcheson*, 674 F.2d 862, 865 (11th Cir. 1982).

private remedies are essential to protecting the integrity of the market. Also, the enterprises' creditors—the capital markets—provide funds for the enterprises and are key to maintaining the nation's flow of credit. Accordingly, the capital markets and the enterprises' borrowers should be protected from any conservator "superpowers" because these powers would disrupt commercial expectations within the secondary markets and constrict the flow of credit. Thus the rights of the borrowers and creditors must not be disregarded, even in the event of the enterprises' insolvency. Rather, all interests of the enterprise—from the private and the public sectors—should be balanced to achieve a viable reorganization that would continue the enterprise's business operations, thereby preserving the availability of credit.

#### **B. New Standard: The Best Interests of the Enterprise**

The first step toward balancing the valuable interests of the private sector with the enterprises' public mission is recognizing the best interests of the enterprise as the new standard to govern reorganization. Continuing operation, however modified, which does not unduly hinder the flow of credit to the enterprise's targeted borrowers would be in the best interest of the enterprise. To maintain the supply of loans to borrowers, the interests of creditors must also be protected. Therefore, the best interests of the enterprise would be served by a fair balancing between creditors' protection and maintenance of the availability of credit to borrowers. The public's interest would be served by protecting the enterprise's agenda to provide credit to homeowners, farmers, students, and other disadvantaged borrowers.

Enterprises, as quasi-private corporations, were created specifically to take advantage of private business and markets.<sup>286</sup> The traditional corporate model of maximization of shareholder wealth is inapplicable to the enterprises. The government supremacy standard that evolved from the failed banks and thrifts<sup>287</sup> is equally inapplicable to enterprises because it recognizes only one side of the enterprise equation—the governmental interest—while disregarding the equally important private sector interests.

Even though twenty-eight states have enacted corporate constituency statutes that enable corporate directors to consider the interests of the corporation and the corporate community,<sup>288</sup> there has yet to be sig-

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286. See *Osborn v. Bank of the United States*, 22 U.S. (9 Wheat.) 738, 763 (1824); *supra* text accompanying note 114.

287. See *supra* notes 182-197 and accompanying text.

288. See *supra* notes 86-88 and accompanying text.

nificant case law that develops and defines these principles.<sup>289</sup> The enterprises' corporate community, which includes shareholders, creditors, bondholders, borrowers, employees, and the government, would be better served with a Congressional directive stating that all rights of the private and public sector shall be considered in the event of enterprise insolvency. The balancing of competing interests should be done before a major conflict materializes. Defining rights upon a bankruptcy or other default is one of the most important aspects of a lease, mortgage, contract, and even marriage. At the time the parties enter into a lease, mortgage, or prenuptial agreement, each party desires a mutually satisfying relationship. Therefore, defining rights upon a party's bankruptcy or default is done prospectively in the spirit of conciliatory good faith. So, if the marriage falters, the tenant's roof leaks, or the borrower fails to repay the loan, and the parties' relationship becomes adversarial, preordained mechanisms determine the balance of competing interests.

The enterprises, as federal instrumentalities, can be considered partnerships between the private and public sectors. Federal statutes and rules constitute the partnership agreement. In the Safety and Soundness Act of 1992, Congress amended the enterprises' partnership agreements to provide that if an enterprise falls into financial trouble, a government conservator will be appointed.<sup>290</sup> Upon the appointment of the conservator, government interests supersede those of private parties. The concept that a government-appointed conservator could fairly consider private-sector interests in troubled times is naive and inconsistent with the lessons learned from the bank and thrift crisis. In the midst of a financial crisis, the government-appointed conservator would be incapable of fairly balancing the public and private interests. Even if Congress instructed the conservator to balance the interests of all parties, the conservator, acting alone and with great discretion, could easily succumb to public policy and political factors.<sup>291</sup> Proper balancing requires the consideration of all relevant factors within a structure in which the competing parties can articulate their concerns.<sup>292</sup>

Because of the complexity in defining the competing private- and public-sector rights if an enterprise becomes insolvent, balancing the rights of creditors while maintaining the government's interest in provid-

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289. See Symposium, *supra* note 89; see also Carney, *supra* note 88.

290. See *supra* notes 159-172 and accompanying text.

291. For a discussion of how public policy and political factors can affect decision making, see Kathleen M. Sullivan, *The Supreme Court 1991 Term, Foreword: The Justices of Rules and Standards*, 106 HARV. L. REV. 22 (1992).

292. *Id.*

ing credit to borrowers protects the nation's economy. The private sector should insist that Congress amend the enterprises' charter to provide a forum for the consideration of all interests upon the insolvency of an enterprise. This forum should allow input from the entire enterprise community—shareholders, creditors, borrowers, and the government. This structure is not foreign to Congress or to the private sector, as it is the basic principle behind the Federal Bankruptcy Code.<sup>293</sup>

### C. Enterprise Reorganization

A standard that considers the best interests of the enterprise in the context of its public mission, as well as the competing interests of the private sector, is most appropriate in a bankruptcy proceeding. Federally insured banks and thrifts are excluded from the bankruptcy code because Congress preferred speedy resolution of the failed associations through purchase and assumption transactions in order to protect the stability of and public confidence in the nation's banking industry.<sup>294</sup> This argument against bankruptcy, however, does not apply to an enterprise. Reorganization of an enterprise could not occur quickly, and bankruptcy would create no greater stigma to an enterprise than would the appointment of a government conservator. Moreover, bondholders and other creditors would probably prefer a bankruptcy proceeding, which provides a forum for the creditors rather than the dictatorial government conservatorship used in the bank and thrift crisis.

One of the aims of bankruptcy is that creditors share losses equitably to prevent a race to claim the debtor's limited assets.<sup>295</sup> When banks and thrifts failed, the government demanded priority over other creditors to the assets of debtors and related third parties. If enterprises fail, their creditors would not even be guaranteed their debt liquidation value, since enterprises would not be liquidated immediately and would be left subject to the discretion of the government-appointed conservator. Bankruptcy would protect the enterprises' assets from a race between the creditors and the government while allowing for reorganization through a binding debt adjustment plan.<sup>296</sup> Further, bankruptcy provides the

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293. See generally COLLIER ON BANKRUPTCY (15th ed. supp. 1992).

294. *Gunter v. Hutcheson*, 674 F.2d 862, 865, 870 (11th Cir.), cert. denied, 459 U.S. 826 (1982).

295. See *supra* note 90; see also Alberto Ganzalo Santos, Note, *Beyond Baker and Brady: Deeper Debt Reduction for Latin American Sovereign Debtors*, 66 N.Y.U. L. REV. 66, 97 (1991).

296. Chapter 9 of the Bankruptcy Code provides for the reorganization and adjustment of debts of municipalities. 11 U.S.C. §§ 901-946 (1988). Municipalities include political subdivisions or public agencies or instrumentalities of a state. 11 U.S.C. § 101(34). Similar to enter-



mechanism for creditors, other private interests, and the government to participate in the reorganization. The purpose of the bankruptcy should be to permit debt adjustment so that the enterprise could be reorganized without cost to the federal government. Federal assistance should be an option, not a necessity.

The best interests of the corporation should guide the reorganization of an enterprise.<sup>297</sup> If that were the case, government interests would not be dominant or controlling. Instead, the competing interests of the shareholders, creditors, borrowers, and government would be balanced in the reorganization proceeding to insure the continued operation of the enterprise and the fair allocation of sacrifice among the interested parties.

## VII. Conclusion

The enterprises, as quasi-public corporations, have successfully achieved their mission to improve and stabilize credit. The enterprises' secondary markets, with their mortgage-backed securities and other obligations, quickly found an important niche in the nation's economy. The enterprises are clearly "too big to fail," as liquidating an enterprise would significantly disrupt the nation's economy. The bank and thrift crisis was a costly experience in many respects. We should learn our lessons by rejecting the government supremacy standard and the appointment of a conservator for financially troubled enterprises. While enterprise ties to the government are strong, their responsibilities to shareholders, borrowers, and creditors are equally important. The private sector should demand that Congress carefully consider the rights of all parties upon enterprise insolvency. Once an enterprise falls into financial trouble and a conservator is appointed, the power will have shifted and the private sector will have no ability to limit agency power. The private sector should vigorously challenge regulatory power to appoint a conservator before a problem arises.

The federal government did not create depositors, but merely sought to protect their interests after the Great Depression. However, Congress did create the enterprises, as partnerships between the public and private sectors, and therefore the federal government should be responsible to the enterprises' shareholders, creditors, and borrowers.

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prises, the public nature of municipalities prevents liquidation and the purpose of municipalities' bankruptcies are to permit financially distressed public entities to seek protection from creditors while formulating a reorganization plan. 4 COLLIER ON BANKRUPTCY § 900.02, at 900-13 (15th ed. Nov. supp. 1991).

297. See Steven M. H. Wallman, *The Proper Interpretation of Corporate Constituency Statutes and Formulation of Director Duties*, 21 STETSON L. REV. 163 (1991).